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SRI LANKA

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2024 ARTICLE IV CONSULTATION AND SECOND REVIEW UNDER THE EXTENDED FUND FACILITY, REQUEST FOR MODIFICATION OF PERFORMANCE CRITERION, AND FINANCING ASSURANCES REVIEW—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR SRI LANKA

In the context of the Staff Report for the 2024 Article IV Consultation and Second Review Under the Extended Fund Facility, Request for Modification of Performance Criterion, and Financing Assurances Review, the following documents have been released and are included in this package:

- A **Press Release** including a statement by the Chair of the Executive Board and summarizing the views of the Executive Board as expressed during its June 12, 2024 consideration of the staff report on issues related to the Article IV Consultation and the IMF arrangement.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 12, 2024, following discussions that ended on March 21, 2024, 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 May 29, 2024.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Sri Lanka.

The documents listed below have been or will be separately released

Selected Issues

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

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IMF Executive Board Concludes 2024 Article IV Consultation with Sri Lanka and Completes the Second Review Under the Extended Fund Facility

FOR IMMEDIATE RELEASE

- The IMF Executive Board completed the 2024 Article IV Consultation and Second Review under the 48-month Extended Fund Facility with Sri Lanka, providing the country with immediate access to SDR 254 million (about US $336 million) to support its economic policies and reforms.

- Performance under the program has been strong. All quantitative targets for end-December 2023 were met, except the indicative target on social spending. Most structural benchmarks due by end-April 2024 were either met or implemented with delay. Nevertheless, the economy is still vulnerable and the path to debt sustainability remains knife-edged. Sustaining the reform momentum and efforts to restructure debt are critical to put the economy on a path towards lasting recovery and debt sustainability.

- The Article IV Consultation focused on wide-ranging reforms to restore macroeconomic stability and debt sustainability, maintain price stability, safeguard financial stability, rebuild external buffers, and implement growth-oriented structural reforms, including by strengthening governance.

Washington, DC – June 12, 2024: The Executive Board of the International Monetary Fund (IMF) completed the second review under the 48-month Extended Fund Facility (EFF) Arrangement, allowing the authorities to draw SDR 254 million (about US$336 million). This brings the total IMF financial support disbursed so far to SDR 762 million (about US$1 billion).[1] The Executive Board also concluded the 2024 Article IV Consultation with Sri Lanka.[2]

The EFF arrangement for Sri Lanka was approved by the Executive Board on March 20, 2023 (see Press Release No. 23/79) in an amount of SDR 2.286 billion (395 percent of quota or about US$3 billion. The first review of the EFF was completed by the Executive Board on December 12, 2023 with disbursements of SDR 254 million (about US$337 million; see Press Release No. 23/439).

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[1] SDR figures are converted at the market rate of U.S. dollar per SDR on the day of the Board approval.

[2] 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.

The EFF-supported program aims to restore Sri Lanka's macroeconomic stability and debt sustainability, mitigate the economic impact on the poor and vulnerable, rebuild external buffers, safeguard financial sector stability, and strengthen governance and growth potential.

Signs of economic recovery are emerging. Real GDP expanded by 3 percent (y-o-y) in the second half of 2023. May 2024 inflation was 0.9 percent and gross international reserves increased to US$5.5 billion by end-April 2024. The primary balance improved to a surplus with tax revenue increasing to 9.8 percent of GDP in 2023. Despite improvements in non-performing loans, pockets of vulnerabilities remain in the banking sector.

The recovery remains gradual, and the medium-term growth potential hinges on appropriate policy settings. Growth is projected to recover moderately in 2024-25 given constrained bank credit and fiscal consolidation, while facing uncertainties around the debt restructuring and policy direction following the elections. Inflation is expected to temporarily increase due to one-off factors. The current account is expected to remain positive in 2024, driven by improved tourist arrivals and remittances. Domestic risks could arise from waning reform momentum, especially on revenue mobilization. External risks are associated with intensified regional conflicts, commodity price volatility, and a global slowdown. Slow progress in debt restructuring could widen financing gaps.

Following the Executive Board's discussion, Mr. Kenji Okamura, Deputy Managing Director and Acting Chair, issued the following statement:

"Sri Lanka's performance under its Fund-supported program remains strong. All quantitative targets were met, except for the marginal shortfall of indicative target on social spending. Most structural benchmarks were either met or implemented with delay. Reforms and policy adjustment are bearing fruit. The economy is starting to recover, inflation remains low, revenue collection is improving, and reserves continue to accumulate. Despite these positive developments, the economy is still vulnerable and the path to debt sustainability remains knife-edged. Important vulnerabilities associated with the ongoing debt restructuring, revenue mobilization, reserve accumulation, and banks' ability to support the recovery continue to cloud the outlook. Strong reform efforts, adequate safeguards, and contingency planning help mitigate these risks.

"To restore fiscal sustainability, sustained revenue mobilization efforts, promptly finalizing the debt restructuring in line with program targets, and protecting social and capital spending remain critical. Advancing public financial management will help enhance fiscal discipline, and strengthening the debt management framework is also needed.

"Monetary policy should continue prioritizing price stability, supported by a sustained commitment to refrain from monetary financing and safeguard central bank independence. Continued exchange rate flexibility and gradually phasing out the balance of payments measures remain critical to rebuild external buffers and facilitate external rebalancing.

"Restoring bank capital adequacy and strengthening governance and oversight of state-owned banks are top priorities to revive credit growth and support economic recovery.

"The authorities need to press ahead with their efforts to address structural challenges to unlock long-term potential. Key priorities include steadfast implementation of the governance reforms; further trade liberalization to promote exports and foreign direct investment; labor reforms to upgrade skills and increase female labor force participation; and state-owned enterprise reforms to improve efficiency and fiscal transparency, contain fiscal risks, and promote a level playing field for the private sector.

Executive Board Assessment[3]

Executive Directors commended the authorities' strong performance under the Fund-supported program, noting that reforms are bearing fruit. The economy has started to recover, inflation remains low, revenue collection is improving, and reserves continue to accumulate. Directors underscored, however, that important vulnerabilities and uncertainties remain, including with respect to the ongoing debt restructuring and the upcoming elections. Against this backdrop, they called on the authorities to continue strengthening macroeconomic policies to restore economic stability and debt sustainability and to sustain the reform momentum to promote long-term inclusive growth.

Directors underscored that restoring fiscal sustainability requires additional revenue measures underpinning the 2025 Budget, further tax administration reforms, as well as limiting tax exemptions and making them more transparent. They called for protecting growth-enhancing and social spending, and for improving the social safety net. Directors welcomed the submission of the new Public Financial Management bill to Parliament, which would strengthen fiscal discipline and establish a solid fiscal framework. They noted that further efforts to strengthen the debt management framework are also needed. Directors welcomed the progress on achieving cost-recovery in energy pricing, noting its criticality for containing risks from state-owned enterprises (SOEs).

Directors welcomed the progress made to advance debt restructuring to restore Sri Lanka's debt sustainability. They called for a swift finalization of the Memorandum of Understanding with the Official Creditor Committee and final agreements with the Export-Import Bank of China. Directors stressed the importance of seeking comparable, transparent, and timely completion of restructurings with external private creditors consistent with program targets.

Directors emphasized that maintaining price stability remains the top priority for monetary policy, which requires anchoring inflation expectations, continuing to refrain from monetary financing, and the gradual unwinding of government security holdings as markets allow. They

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[3] 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.

also stressed the importance of strengthening central bank independence. Directors underscored the need to continue building external buffers, while maintaining exchange rate flexibility to facilitate external rebalancing and preserve the credibility of the inflation targeting regime. They called for gradually phasing out the balance of payments measures.

Directors underscored the need to strengthen financial sector resilience to support the recovery. They called for swift completion of the restructuring of remaining domestic law, foreign currency loans and for adequate recapitalization of commercial and state-owned banks. Directors welcomed the enactment of the Banking Act amendments and emphasized the importance of their effective implementation to enhance supervision and the governance of state-owned banks. They also called for further efforts to strengthen the anti-money laundering and counter-terrorism financing framework.

Directors stressed that pressing ahead with governance and structural reforms, supported by development partners and IMF capacity development, is crucial to unlock growth potential. They welcomed the publication of the authorities' action plan on the key governance reforms recommended in the Governance Diagnostic Report and called for its steadfast implementation. Directors also recommended prioritizing reforms to further liberalize trade, improve the investment climate and SOE efficiency, reduce gender gaps in the labor market, and mitigate climate vulnerabilities.

Sri Lanka: Selected Economic Indicators 2021–2029

	2021	2022	2023	2024	2025	2026	2027	2028	2029
			Prel.	Projections					
GDP and inflation (in percent)									
Real GDP	4.2	-7.3	-2.3	2.0	2.7	3.0	3.1	3.1	3.1
Inflation (average) 1/	6.0	45.2	17.4	7.0	5.8	5.4	5.2	5.1	5.0
Inflation (end-of-period) 1/	12.1	54.5	4.0	6.9	5.5	5.4	5.2	5.1	5.0
GDP Deflator growth	8.0	47.5	17.5	9.8	6.9	5.4	5.2	5.1	5.0
Nominal GDP growth	12.6	36.6	14.8	11.9	9.8	8.5	8.5	8.3	8.3
Savings and investment (in percent of GDP)									
National savings	33.0	27.6	33.9	32.5	31.0	31.3	31.9	31.8	31.8
Government	-7.3	-6.4	-6.0	-3.4	-1.0	-0.1	0.3	0.7	0.7
Private	40.4	34.0	39.9	35.9	31.9	31.4	31.6	31.1	31.0
National investment	36.7	28.6	30.8	32.1	32.1	32.4	32.8	32.7	32.6
Government	7.4	5.5	3.7	5.0	5.1	5.2	5.1	5.2	5.2
Private	29.4	23.1	27.1	27.1	27.0	27.3	27.7	27.5	27.4
Savings-Investment balance	-3.7	-1.0	3.1	0.5	-1.1	-1.2	-0.9	-0.9	-0.8
Government	-14.7	-11.9	-9.6	-8.4	-6.0	-5.3	-4.8	-4.5	-4.4
Private	11.0	10.9	12.8	8.8	4.9	4.1	3.9	3.6	3.6
Public finance (in percent of GDP)									
Revenue and grants	8.3	8.4	11.1	13.6	15.1	15.3	15.4	15.4	15.4
Expenditure	20.0	18.6	19.4	20.9	20.3	19.9	19.5	19.2	19.2
Primary balance	-5.7	-3.7	0.6	1.0	2.3	2.3	2.3	2.3	2.3
Central government balance	-11.7	-10.2	-8.3	-7.3	-5.2	-4.6	-4.1	-3.8	-3.8
Central government gross financing needs	31.0	34.1	27.8	24.9	23.7	20.5	16.6	13.1	11.9
Central government debt	102.7	115.9	109.8	108.8	108.4	108.3	106.6	103.2	100.1
Public debt 2/	114.8	126.3	115.7	114.2	113.1	112.5	110.2	106.5	103.1
Money and credit (percent change, end of period)									
Reserve money	35.4	3.3	-1.5	18.8	11.0	8.5	8.5	8.3	8.3
Broad money	13.2	15.5	7.3	14.9	10.4	8.5	8.5	8.3	8.3
Domestic credit	19.5	18.8	-1.2	9.3	3.6	2.5	2.3	2.4	6.7
Credit to private sector	13.1	6.4	-0.8	7.2	9.2	9.3	9.5	9.4	9.3
Credit to private sector (adjusted for inflation)	7.2	-38.8	-18.2	0.2	3.4	4.0	4.3	4.3	4.3
Credit to central government and public corporations	26.5	31.1	-1.6	11.0	-0.9	-3.4	-4.7	-5.5	3.2
Balance of Payments (in millions of U.S. dollars)									
Exports	12,499	13,106	11,911	12,913	13,624	14,261	14,903	15,591	16,384
Imports	-20,638	-18,291	-16,811	-20,059	-22,565	-23,706	-24,362	-25,255	-26,363
Current account balance	-3,285	-744	2,644	412	-926	-1,031	-804	-819	-840
Current account balance (in percent of GDP)	-3.7	-1.0	3.1	0.5	-1.1	-1.2	-0.9	-0.9	-0.8
Current account balance net of interest (in percent of GDP)	-2.1	0.1	4.3	2.8	1.3	1.1	1.5	1.6	1.5
Export value growth (percent)	24.4	4.9	-9.1	8.4	5.5	4.7	4.5	4.6	5.1
Import value growth (percent)	28.5	-11.4	-8.1	19.3	12.5	5.1	2.8	3.7	4.4
Gross official reserves (end of period)									
In millions of U.S. dollars	3,139	1,898	4,387	5,605	7,174	9,262	13,466	15,105	15,286
In months of prospective imports of goods & services	2.0	1.2	2.4	2.7	3.3	4.1	5.8	6.2	6.3
In percent of ARA composite metric	24.7	16.3	37.8	47.9	58.6	73.1	100.2	108.7	108.5
Usable Gross official reserves (end of period) 3/									
In millions of U.S. dollars	1,565	462	2,951	4,169	7,174	9,262	13,466	15,105	15,286
In months of prospective imports of goods & services	1.0	0.3	1.6	2.0	3.3	4.1	5.8	6.2	6.3
In percent of ARA composite metric	12.3	4.0	25.4	35.6	58.6	73.1	100.2	108.7	108.5
External debt (public and private)									
In billions of U.S. dollars	58.4	57.4	52.7	53.6	55.6	58.0	62.3	64.0	65.8
As a percent of GDP	65.9	77.0	62.5	61.1	64.4	65.7	68.5	67.2	65.0
Memorandum items:									
Nominal GDP (in billions of rupees)	17,612	24,064	27,630	30,917	33,958	36,839	39,959	43,287	46,869
Exchange Rate (period average)	198.8	322.6	327.5	…	…	…	…	…	…
Exchange Rate (end of period)	200.4	363.1	323.9	…	…	…	…	…	…

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). The debt statistics currently assume the external debt restructuring to have been completed at end 2023.

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

INTERNATIONAL MONETARY FUND

SRI LANKA

May 29, 2024

STAFF REPORT FOR THE 2024 ARTICLE IV CONSULTATION AND SECOND REVIEW UNDER THE EXTENDED FUND FACILITY, REQUEST FOR MODIFICATION OF PERFORMANCE CRITERION, AND FINANCING ASSURANCES REVIEW

EXECUTIVE SUMMARY

Context. Reform efforts are bearing fruit with the economy starting to recover, inflation remaining low, revenue collection improving, and reserves continuing to accumulate. Performance under the program, the design of which benefitted from the 2021 Article IV recommendations, has been strong. Nevertheless, the economy is still vulnerable and the path to debt sustainability remains knife-edge. Sri Lanka faces considerable uncertainties associated with the upcoming presidential elections and ongoing debt restructuring. Sustaining the reform momentum is critical to safeguarding the hard-earned gains and ensuring Sri Lanka can emerge from one of its most severe economic crises.

Program Status. In March 2023, the IMF's Executive Board approved a 48-month Extended Arrangement under the Extended Fund Facility (EFF), with access to Fund resources of SDR 2.286 billion (395 percent of quota or about US$3 billion) and a first disbursement of SDR 254 million (about US$333 million). A second disbursement of SDR 254 million was approved after the first review on December 12, 2023. Upon completion of the second review, Sri Lanka would have access to an additional SDR 254 million.

Program Performance. All quantitative targets for end-December 2023 were met, except the IT on social spending; all continuous Quantitative Performance Criteria (QPCs) were observed. By end-April 2024, all continuous Structural Benchmarks (SBs) and ten out of fourteen SBs were either met or implemented with a delay. The prior action on the parliamentary submission of the PFM bill was met. Full operationalization of the Bulk Supply Transaction Account (BSTA) and the enactment of asset recovery bill were reprogrammed to later this year. The authorities discussed with staff the breach of the Monetary Policy Consultation Clause's (MPCC) inner band.

Article IV. Discussions focused on: (i) fiscal reforms to restore debt sustainability and reinstate fiscal discipline while supporting social and developmental objectives; (ii) monetary and financial reforms to maintain price stability and enhance financial resilience; (iii) multi-pronged policy reforms to reduce external imbalances; and (iv) structural reforms to strengthen governance and promote inclusive and sustainable growth.

Policy Recommendations

- **Fiscal Policy**. Sustained revenue mobilization, promptly finalizing the debt restructuring in line with program targets, and protecting priority spending remain critical to restoring fiscal sustainability while promoting inclusive growth. Advancing public financial management to enhance fiscal discipline and state-owned enterprise reforms will help enhance fiscal transparency and contain fiscal risks.

- **Monetary and Exchange Rate Policy**. Monetary policy should prioritize maintaining price stability, supported by sustained commitment to prohibit monetary financing and to safeguard Central Bank independence. Continued exchange rate flexibility and gradually phasing out the Balance of Payments (BoP) measures remain critical to rebuild external buffers and facilitate rebalancing.

- **Financial Policy**. Restoring bank capital adequacy and strengthening governance and oversights of state-owned banks are top priorities to revive credit growth and support economic recovery.

- **Anti-Corruption and Governance Reforms**. Steadfast implementation of the governance reforms would support the authorities' broader reform agenda in unlocking Sri Lanka's growth potential**.**

- **Structural Policy**. Addressing Sri Lanka's prolonged structural impediments hinges on comprehensive and sustained reform efforts. Top priorities include further trade liberalization to promote exports and foreign direct investment, labor reforms to upgrade skills and increase female labor force participation, SOE reforms to improve efficiency, promoting a level playing field for the private sector, and mitigating climate vulnerabilities.

  Requests. Staff supports the authorities' request for (i) the completion of the second review under the extended EFF arrangements; (ii) reprogramming two SBs to later dates; and (iii) the modification of the end-June 2024 performance criterion to lock in reserves overperformance and the introduction of a new IT.

Approved By
Sanjaya Panth (APD) and Martin Čihák (SPR)

Discussions were held in Colombo during March 7–21, 2024. The mission met with President and Finance Minister Wickremesinghe, Central Bank of Sri Lanka Governor Weerasinghe; Secretary to the Treasury Siriwardana; other senior officials; P. Harischandra (OED); and representatives of the Parliamentary Opposition, the business community, civil society, and international partners. The staff team comprised P. Breuer and K. Svirydzenka (Co-Heads), H. Selim, Y. Zhang, S. Dhungana (all APD), S. Kwalingana (SPR), D. Rozhkov (FAD), H. Miao (both MCM), D. Robinson (LEG), S. Jahan (resident representative), and M. Abeyawickrama (local economist). M. Adams (MCM) participated in the discussions remotely. R. Yang, A. Guansing and P. Tanseco (all APD) assisted in the preparation of this report.

CONTENTS

TABLES

ANNEXES

APPENDIX

Acronyms

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

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

CONTEXT

1. **The ongoing reform efforts to restore macroeconomic imbalances reflect strong traction of policy recommendations since the crisis**. The 2021 AIV had recommended restoring macroeconomic stability through fiscal consolidation, tighter monetary policy, transition towards a more flexible exchange rate, rebuilding international reserves, and safeguarding financial stability (Annex I). Subsequently, Sri Lanka entered a crisis and requested a Fund-supported program, prompting the authorities to implement fundamental reforms. Tax policy measures and expenditure restraint have underpinned a sizeable adjustment and cost-recovery energy pricing was adopted. A new Central Bank Act (CBA), approved in July 2023, significantly enhanced the autonomy of the Central Bank of Sri Lanka (CBSL), and monetary financing was phased out. A revised Banking Act (BA) enhanced supervisory powers, the exchange rate has become more flexible, reserves were rebuilt from critically low levels, and BoP measures are being relaxed. Social safety nets were enhanced. The authorities have been advancing debt restructuring to restore debt sustainability.

2. **This review prioritized policies to entrench economic stabilization and set the stage for addressing long-term challenges in the context of the Article IV**. The program is starting to bear fruit with real Gross Domestic Product (GDP) expanding, inflation remaining low, revenue collection strengthened, and reserves continuing to grow. Significant efforts are still needed to ensure a sustainable recovery. In this context, the authorities remain committed to mobilize revenues, restore debt sustainability, maintain price stability, strengthen external buffers, safeguard financial stability, and advance the implementation of comprehensive governance and structural reforms.

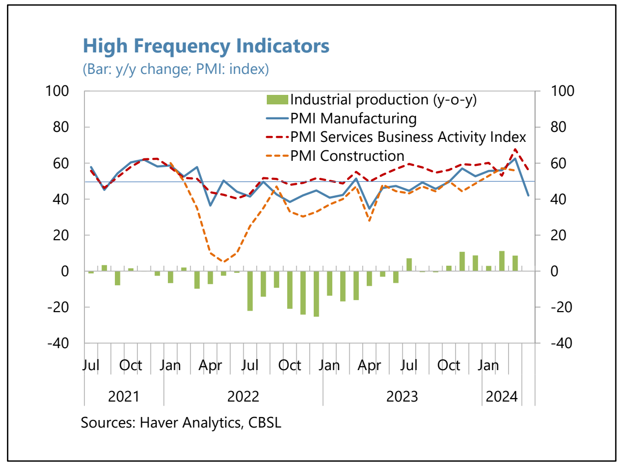
3. **Navigating the electoral cycle is critical to safeguard reform momentum**. Presidential elections are expected in the fall of 2024. Under the Constitution, parliamentary elections need to take place by August 2025. In the past, the run-up to elections was accompanied by policy slippages and a waning reform momentum. To weather the election-related uncertainties, the program introduced safeguards including new conditionality to frontload revenue measures and a tighter quantitative criterion to lock in overperformance on reserve accumulation.

RECENT MACROECONOMIC DEVELOPMENTS

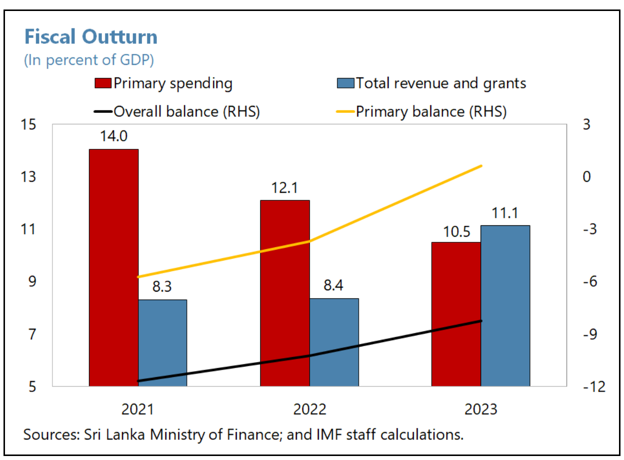
4. **Signs of recovery are emerging**. Real GDP posted two consecutive quarters of expansion (1.6 and 4.5 percent y-o-y in Q3 and Q4) in 2023. The recovery has been broadening across sectors and reflects stronger private consumption and investment.[1] High-frequency indicators point to

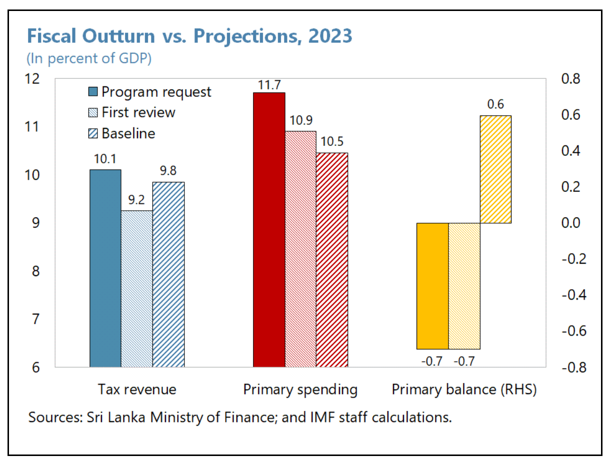
[1] There were large revisions to the GDP components by expenditure approach in the last 2 years and most notably in H2 2023. Therefore, GDP on the demand side should be interpreted with caution. The authorities have requested IMF technical assistance to improve data quality in this respect.

continuing recovery of manufacturing, construction, and services activity this year[2]. Inflation has been in the low single digits since July 2023 despite temporary upticks in early 2024, led by increased food inflation and new fiscal measures.



5. The external position improved, but imbalances remain. The current account balance registered a surplus of 3.1 percent of GDP in 2023, up from a deficit of 1.0 percent in 2022. The stronger outturn was driven by (i) larger import compression partially offset by weaker exports, (ii) buoyant tourism and workers' remittances, and (iii) moratorium on interest payment for restructurable debt. Gross reserves increased faster than expected to US$4.4 billion (2.4 months of prospective imports) as of end-December 2023. Overall, the external position in 2023 is assessed to be moderately weaker than implied by fundamentals and desired policies, reflecting further needs for fiscal consolidation, exchange rate flexibility, and reserve accumulation (Annex V). The CBSL has accelerated reserve accumulation this year, with US$1.5 billion net purchases through mid-April—more than half of the projected increase for 2024. By end-April, gross official reserves had increased to US$5.5 billion, equivalent to 2.6 months of prospective imports or 46 percent of the ARA metric.





6. The primary balance adjustment in 2023 was significantly better than forecasted; however, the interest bill remains high. Compared to 2022, the primary balance improved from a deficit of 3.7 to a surplus of 0.6 percent of GDP, well above the targeted deficit of 0.7 percent (text figures). Tax revenue[3] increased from 7.3 to 9.8 percent of GDP in 2023 and the number of taxpayers more than doubled to nearly one million. Primary spending declined from 12.1 to 10.5 percent of

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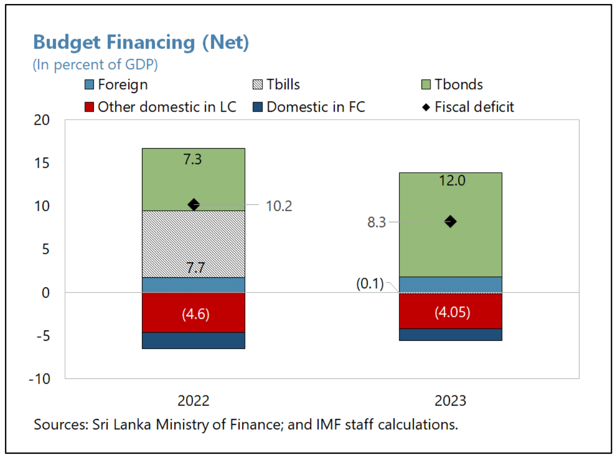
[2] April manufacturing PMI showed a small dip to contractionary territory due to a decline in new orders and working days during the festive season.

[3] Mainly through increases in income taxes, Value-Added Tax (VAT) and the Social Security Contribution Levy.



GDP in 2023 due to a lower wage bill and the repayment to the Treasury of the Ceylon Petroleum Corporation (CPC) loan (0.9 percent of GDP).[4] Primary current spending remained broadly stable at 8.1 percent of GDP while capital spending (excluding net lending) increased marginally to 3.3 percent of GDP. The large interest bill (8.9 percent of GDP) given elevated T-bill rates (¶32) offset some of the revenue gains, resulting in an overall deficit of 8.3 percent of GDP. Reliance on net issuance of T-bills declined as the CBSL reduced its holdings (¶34 and text figure) and the Treasury built a cash buffer (¶29). Favorable fiscal and external developments (¶5) reduced the T-bill rates from over 30 percent to around 10 percent by end-April, 2024.

7. **Pockets of vulnerabilities remain in the banking sector**. In 2023H2**,** banks closed most of their FX net open positions from the restructuring of Sri Lanka Development Bond and Foreign Currency Banking Unit FX loans to the government thanks to normalized FX liquidity conditions. The non-performing loans (NPLs) ratio declined marginally since last September (from 13.6 to 13.1 percent in January 2024) with improved debt collection and NPLs workout processes. Nonetheless, banks continue to face elevated credit risk, shrinking net interest margins, large exposure to the public sector, and the effects from debt restructuring. The joint CBSL-MoF recapitalization plan will ensure adequate capitalization levels based on the Asset Quality Review (AQR) results and impact of debt restructuring. Recapitalization plans for the five Phase I banks, originally received by the CBSL in January 2024, cannot be finalized before settling the restructuring terms of CPC's FX loans held by the two state-owned banks (¶39).[5] Private credit expanded modestly since June 2023, after sharp contraction.

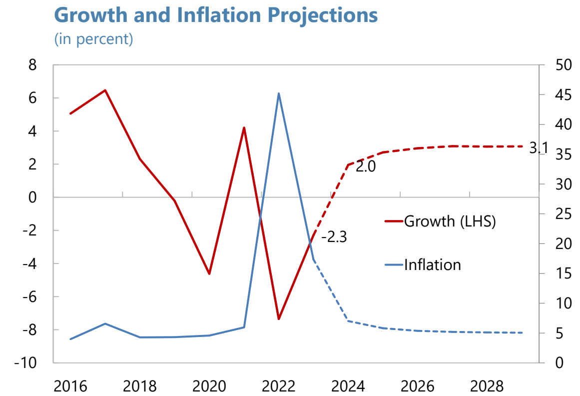
OUTLOOK AND RISKS

8. **The near-term outlook is slightly upgraded, but the recovery remains gradual and the medium-term growth potential hinges on appropriate policy settings**. Following a better outturn in 2023, growth is projected to recover moderately at 2 and 2.7 percent in 2024-25 given constrained bank credit and fiscal consolidation, while facing uncertainties around the debt restructuring and the elections (Text figure). Inflation is expected to exceed the 5 percent target in 2024 due to new fiscal measures and base effects before returning to target after the transitory effects dissipate. The current account is expected to remain positive in 2024, driven by improved

[4] The repayment of the CPC loan is part of the implementation of the SOE balance sheet restructuring strategy (June 2023 SB) ¶25.

[5] A contingency has been set aside to enable public capital injections to the two state-owned banks if needed to offset the loss from debt restructuring. Private sector banks are expected to meet their own capital needs.

tourist arrivals and remittances. This is expected to be partially offset by FX deposits abroad amid the absence of domestic dollar-denominated investment opportunities. Consequently, gross international reserves (GIR) are projected at US$5.6 billion in 2024 (vs. US$5.3 billion at the first review). The macroeconomic framework reflects the authorities' indicative debt treatment scenario (¶27, 28 and Annex II).



Sources: Authorities and IMF staff estimates

9. Downside risks have subsided somewhat but remain elevated. Given the upgraded outlook (¶8), the external financing path under the program marginally improved relative to the first review. Fiscal financing risks stem from potential difficulties in issuing longer-term bonds, larger-than-envisaged recapitalization needs for banks and the CBSL, and adverse effects from the restructuring of domestic FX debt. *Domestic risks* could arise from waning reform momentum, especially on revenue mobilization, and the possibility of social unrest. *External risks* associated with intensified regional conflicts, commodity price volatility, and a global slowdown could disrupt trade, capital flows and lead to sharp exchange rate depreciation and inflation pressure. Slow progress in debt restructuring would worsen the BoP and widen financing gaps (Annex III, ¶50 discusses enterprise risks).

10. Program risks are managed through contingency measures. Program overperformance is locked in. Revenue shortfalls will continue to be mitigated by stronger ex-ante conditionality, a focus on revenue administration reforms and as a last resort capital spending under-execution. The authorities continue to engage closely with creditors to minimize debt restructuring delays. Policy slippages could occur around the elections. The authorities committed to refrain from the policies that are inconsistent with the program's objectives.

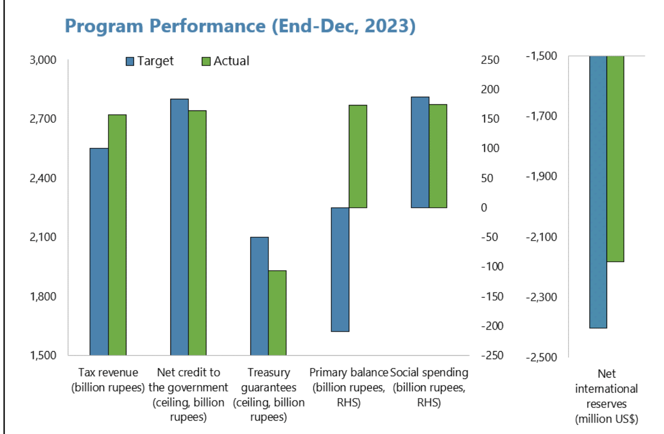
Authorities' Views

11. The authorities broadly agreed with the risk assessment. While acknowledging the risks, the authorities highlighted medium-term concerns on climate change, migration of high-skilled labor, and competitiveness loss; and noted the upside risks associated with the Port City project.

PROGRAM PERFORMANCE

12. Performance of quantitative conditionality at end-December 2023 was strong, with all targets met, except one (Text figure).

- **Fiscal**. The primary balance posted a surplus of Rs. 173.3 billion, surpassing the deficit target of Rs. 209 billion. Tax revenues of Rs. 2,721 billion surpassed the indicative target (IT) floor (Rs. 2,550 billion).[6] The QPCs on arrears and ITs on treasury guarantees and the cost of non-commercial obligations for fuel and electricity were met. The IT on social spending was missed by a slim margin due to the review of the grievances (¶22) and the challenges of opening new bank accounts for beneficiaries.



Sources: Authorities and IMF staff.

- **Monetary and Reserves**. Inflation, at 3 percent, fell within the outer band (2 percent), but outside the inner band of the Monetary Policy Consultation Clause (MPCC) in Q4-2023.[7] The Net Credit to Government (NCG) declined to Rs. 2,742 billion, Rs. 58 billion below the QPC. The continuous QPC on primary market purchases of government securities was observed. Net International Reserves (NIR) reached US$-2.18 billion, exceeding the target.[8]

13. By end-April, most SBs were either met or implemented with delay.

- **Fiscal**. Continuous SBs on setting fuel and electricity prices at cost recovery levels were met. The following end-December SBs were met: (i) parliamentary approval of the 2024 Appropriation Act, (ii) creating and implementing within the Large Taxpayers Unit a High Wealth Individuals (HWI) unit and a design and monitoring unit that includes a strengthened risk management unit, (iii) cabinet approval of reducing the limit on government guarantees, and (iv) cabinet approval of a strategy to build a VAT refund system and achieve a full repeal of the Simplified VAT (SVAT). The SB on the report on Key Performance Indicators (KPIs) for tax administration (due for end-March 2024) was implemented with delay on May 8th, 2024, as the authorities needed time for data preparation. Despite some progress, the end-December SB on BSTA's full operationalization was not met as the account is not yet used to calculate the electricity tariff; it was reset to end-June 2024 **(proposed SB, reset)** (¶24). To ensure the PFM bill is consistent with

[6] Tentative data for March 2024 showed that both ITs on the primary balance and tax revenue were met, with the primary balance estimated at Rs. 316 billion (vs. the IT of Rs. 70 billion) and tax revenue estimated at Rs. 833 billion (vs. the IT of Rs. 750 billion).

[7] Staff held the policy consultation with the authorities to discuss the drivers and policy reactions to the breach of MPCC inner band. Lower-than-expected inflation was largely driven by a stronger Rupee and lower food prices. The dip was followed by an inflation uptick in early 2024 and rising inflation pressure due to tax measures. The authorities only mildly reduced the policy rate by 50 basis points.

[8] Adjustors on program NIR reached US$ 832 million due to a significant shortfall in project financing flows into the government's accounts at the central bank. The end- March 2024 IT was comfortably met with NIR at US$-1.4 billion.

best practice, the parliamentary submission of the PFM bill was delayed (end-February SB) but has been implemented in May 2024 **(Prior Action)** (¶23).[9]

- **Financial**. The end-February 2024 SB on recapitalization plans for Phase 2 banks was met. The Banking Act amendments were approved by Parliament on April 2, 2024, after the end-January deadline **(SB)**, while the full implementation, missed for March 2024, is now expected by June 2024 (**SB)**. The end-June SB to adopt and publish a framework to strengthen the governance of state-owned banks was met ahead of schedule on May 27, 2024.

- **Governance and Anti-corruption**. The end-December SB on publishing the rules for selecting Anti-corruption commissioners was met, while the SB on publishing procurement contracts and the list of firms receiving tax exemptions, including the cost of exemptions, was implemented with delay on February 13, 2024. The authorities published an action plan for governance reforms, guided by the Governance Diagnostic (GD) report, in February 2024. The end-April deadline to enact the Asset Recovery Bill was missed to accommodate much needed public consultation; hence this SB is reset to end-November 2024 **(proposed SB, reset)**.

POLICY DISCUSSIONS

14. In addition to restoring macroeconomic stability and debt sustainability, Sri Lanka needs to lay the foundations towards long-term goals. As the policy adjustments start to take effect, near-term reforms need to continue while longer-term policies are accelerated to achieve stable and inclusive recovery. Fiscal reforms should focus on revenue mobilization, preserving the primary balance path, advancing the debt restructuring, and upgrading the fiscal framework to better manage fiscal risks. On the monetary side, the CBSL needs to continue prioritizing price stability and exchange rate flexibility to maintain its operational independence. A modern financial sector with more effective resolution frameworks and better governance of state-owned banks will support financial intermediation and growth. Governance and other structural reforms are crucial to restoring and sustaining long-run economic and social stability.

A. Fiscal Policy

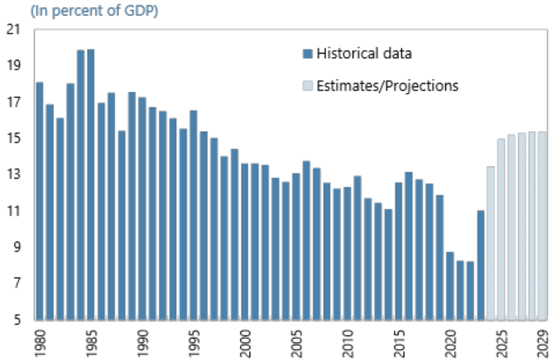
15. Maintaining a sustainable primary balance path, supported by revenue mobilization, is key to restoring fiscal sustainability. The program envisages about 6½ percent of GDP in tax revenue gains between 2022 and 2025 to bring tax revenue to about 14 percent of GDP, in line with Sri Lanka's past and peers (text charts).[10] Significant revenue mobilization has supported the fiscal adjustment since 2022 (¶6), though gaps to historical revenue levels remain large. Additional tax policy and administration measures will be implemented in 2025 (¶17 and 19) to partially compensate for a shortfall from the lost revenue gains from the property tax (¶18) and to achieve

[9] Amendments were needed to ensure (i) that several draft legislations (PPPs, PDMA and SOEs) are consistent with the PFM Bill, and (ii) the application of the PFM Bill to SOEs and public investment management.

[10] By comparison, tax exemptions in 2022 amounted to about 4 percent of GDP.

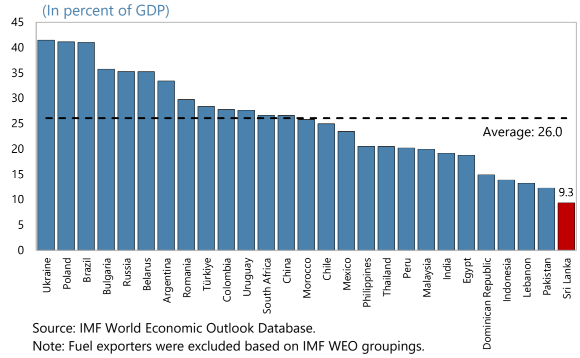
fiscal targets.[11] The 2025 budget will be consistent with program parameters with revenue measures approved ahead of the elections **(proposed SBs)**.[12] The stock of expenditure arrears will be maintained at zero **(QPC)**. The authorities committed to refrain from any tax policy or administrative measures that may erode tax revenue or jeopardize the agreed fiscal path.

Government Revenue to GDP
(In percent of GDP)



Source: Sri Lanka Ministry of Finance; and IMF staff estimates and projections.

General Government Revenue in Emerging Market and Middle-Income Economies, Average 2019-22
(In percent of GDP)



Source: IMF World Economic Outlook Database.
Note: Fuel exporters were excluded based on IMF WEO groupings.

Revenue Mobilization

16. Locking in the revenue overperformance from 2023, this review sets a slightly higher primary balance target for 2024. The 2024 Budget targeted a primary surplus of 0.8 percent of GDP in 2024. Given the stronger revenue outturn in 2023, approved measures underpinning the 2024 budget would increase tax revenue by 0.3 ppts to 12.4 percent of GDP. With broadly unchanged spending execution, the primary surplus is expected to reach 1 percent of GDP in 2024 **(QPC)**. This larger surplus would create an additional buffer to weather higher-than-expected interest payments and reduce domestic financing risks (¶29). Locking in the overperformance will reduce the revenue-based adjustment needs by 0.4 ppts in 2025 (¶17) and partially compensate for the lost revenue gains from the property tax (¶18).

17. Revenue measures will be introduced in 2025 to compensate for shortfalls from the property tax, ensuring the originally agreed revenue path under the program is maintained. Given that the 2023 revenue overperformance is saved permanently (0.3 percent of GDP), tax revenue gains in 2025 equivalent to 1.5 ppt of GDP (instead of 1.9 ppt of GDP at the first review) would be needed to bring the tax ratio to the program target of about 14 percent in 2025 (text table). Revenue gains for 2025 are expected to stem from new measures (0.7 percent of GDP) including (i) tax policy measures (0.4 percent of GDP) and (ii) tax administration measures (0.3 percent of GDP and ¶19). In addition, the lifting of import restrictions on motor vehicles would also contribute to revenue gains (0.8 percent of GDP, slightly revised upwards by 0.1 ppt relative to the

[11] To fully compensate for the property tax shortfall beyond 2025, staff recommends implementing revenue measures identified in the March 2024 TA report on "Property Taxation at the National and Sub-national level" starting 2026. Further measures to reform excises and customs could be identified.

[12] New SBs are introduced for 2025 (¶17).

first review (¶37).[13] All these measures combined including the 2023 overperformance are expected to fully compensate the shortfall from the property and gift inheritance taxes (1.2 percent of GDP). The package of new tax policy measures is expected to be submitted to Parliament by end-June 2024 **(proposed SB)** and approved by end-July 2024 **(proposed SB)** to take effect in January 2025. The authorities committed to adopt additional measures to compensate for unexpected revenue shortfalls.

Revenue and Spending Measures in 2025

(Yield in Percent of GDP)

	First Review	Baseline
Total tax revenue gains	1.9	1.5
Property tax	1.2	0.0
New measures agreed during the second review		0.4
Imputed rental income tax		0.15
Eliminate exemptions on income tax on export of services		0.04
Increase CIT rate from 40 to 45% on betting and gaming, tobacco and liquor		0.08
Replace SCL with VAT		0.04
Impose VAT on supply of digital services		0.04
Lifting import ban on motor vehicles and other imports 2/	0.7	0.8
Improving the VAT compliance gap		0.3
Increase of stamp duty on leases of land from 0.1 percent to 0.2 percent 1/		-0.03
Memo items		
Tax revenue in 2023	9.2	9.8
Tax revenue in 2024	12.1	12.4
Tax revenue in 2025	14.0	13.9

1/ The increase in the stamp duty will result in lower transfers to provincial councils and thus lower total spending.

2/ At program request, the lifting of import restrictions was planned for 2023-2025 with an expected cumulative yield of 1.5 percent of GDP, of which 0.7 percent were planned for 2025. Under the current baseline, the cumulative yield from this measure remains unchanged but is phased on 2024-2025 instead.

18. The introduction of an imputed rental income tax is critical to sustain revenue mobilization efforts. The property tax was initially planned for 2025 but faced institutional impediments.[14] Based on the recent IMF TA, an imputed rental income tax from owner-occupied and vacant residential property would be an appropriate substitute.[15] This tax will be introduced by April 1, 2025, with an exemption threshold and a graduated tax rate schedule to ensure

[13] The yield from this measure has been incorporated in staff's baseline since program request.

[14] These included data sharing and constitutional constraints on revenue sharing between local and central governments.

[15] Imputed rental income is the deemed income that homeowners could earn if they rented out their homes. The tax is imposed on the income of individuals (rather than real property itself) and thus raises central government revenue in accordance with the constitution. A similar tax was previously included in the Inland Revenue Act. No. 10 of 2006. Under this regime, primary residences were exempt and the assessed values for rating purposes were used to determine the base. Given the broad exemption and the use of outdated and downward biased annual values, the tax generated hardly any revenue.

progressivity. The total tax yield (0.4 percent of GDP) would only fully materialize by 2026 (partial yield of 0.2 percent in 2025). Building the data infrastructure is crucial:

- Establishing a database on property valuation[16], that includes information such as assessed values, latest assessment date, and property type in all municipal councils by August 2024 **(proposed SB)**. Other complementary efforts are described in the MEFP ¶9.

- Fully operationalizing a nationwide digital Sales Price and Rents Register (SPRR) by end-March 2025, accessible by the Inland Revenue Department (IRD), the valuation department, the land registry, and the public **(proposed SB)**. This digital SPRR would be the key resource for assessing property values and the imputed rental income tax. To start, a provisional SPRR could be introduced in August 2024.

- Improving data-sharing among relevant government entities through amending the Notaries Act by April 2025 to ensure information on each notarized real property contract is automatically fed into the digital SPRR.

19. The implementation of a VAT compliance improvement program is key for revenue collection in 2025 and onwards. This program is expected to raise about 0.3 percent of GDP in 2025. It will identify, assess, and prioritize the compliance risks for each taxpayer segment and determine a detailed risk management plan, covering taxpayers' education, registration, filing, payment, and risk-based verifications (e.g., by reintroducing taxpayer field visits). Successful implementation requires sufficient resources to IRD (MEFP ¶10) and continuing efforts to repeal the SVAT by April 2025 in line with the measures described in MEFP ¶13.

20. Complementary revenue administration measures would improve tax collection efficiency. IRD already introduced a report on quarterly tax administration KPIs **(SB for March 2024)**. A new KPI is added to improve the functioning of the VAT refund system (starting September 2024). New targets are set for all KPIs up to March 2025 **(proposed SB,** and ¶48**)**. To support IRD digitization, cabinet will approve by August 2024 a prioritized, time-bound, and costed Information Technology Strategic Plan to deliver the Revenue Administration Management Information System (RAMIS) (version 3.0) with functionality enhancements and design improvements **(proposed SB)**. To improve tax collections from large taxpayers, IRD will complete risk profiling of the 100 largest taxpayers and solicit required information as described in MEFP ¶12.

Expenditure Prioritization

21. Reducing the reliance on ad hoc capital expenditure cuts is necessary to secure Sri Lanka's growth potential. Expenditure restraint has been relying heavily on capital spending cuts, which is detrimental to growth. The baseline projects a reversal of this trend with a gradual increase of capital expenditure to 4 percent of GDP in 2024 and 4.6 percent by 2029. In addition, strengthening project selection processes and implementing the recommendations of the

[16] By collecting information from a representative sample of 5,000 standard properties.

forthcoming Public Finance Review by the World Bank (WB) are critical to raise public investment efficiency.

22. Social Safety Nets (SSN) reforms should continue to protect the poor from the adverse effects of the crisis. The authorities have stepped up efforts to improve the targeting, adequacy, and coverage of SSNs since 2023. In the process, they resolved a large number of grievances under the new Welfare Benefit Payment Scheme (*Aswesuma*) by end-February 2024 and started retroactively making the cash transfers due by end-December 2023. The authorities called for a second round of applications by end-March 2024 to address exclusion errors and will periodically assess the Aswesuma scheme to improve its design. Given continued economic hardships, the authorities are seeking Parliamentary approval to extend cash transfers and increase payments for select groups. The authorities plan to implement an Empowerment Program with support from the WB and Asian Development Bank (ADB) to help the beneficiaries graduate from the Aswesuma program.

Public Financial Management

23. The new PFM law will strengthen the fiscal framework and enhance fiscal responsibility. The PFM law - submitted to Parliament in May **(PA)** - will improve fiscal discipline through an enhanced fiscal rules framework, better transparency and accountability, and more efficient budget preparation processes (Annex IV). The authorities will ensure consistency of future bills with the PFM law and committed to adopt implementing regulations of the law by end-December 2025. They committed to fully integrate PPPs with the public investment management process and ensure the MoF's gatekeeper role in evaluating the viability and affordability of projects. To further improve fiscal transparency, the authorities will prepare a fiscal strategy statement for 2025 by end-June 2024, including the medium-term fiscal framework (MTFF) **(SB)**. They will submit a fiscal risks statement, identifying the main fiscal risks. A medium-term PFM Reform Strategy and Action Plan will be prepared and published by end-December 2024.

24. More vigilance is needed to maintain cost-recovery pricing and manage fiscal risks from the CPC and Ceylon Electricity Board (CEB). After introducing cost-recovery energy pricing in 2022, CPC and CEB made profits in 2023. A large downward revision of electricity tariffs (21.9 percent on average) on March 5 should maintain cost recovery on a forward-looking basis, given the projections of hydro power usage, favorable exchange rate and interest rate developments. Any unforeseen deterioration in the assumptions will be corrected by an increase in tariffs. Despite some improvement, the full operationalization of the BSTA, which should allow the use of buffers between quarterly tariff revisions, has been delayed due to the lack of formal power purchase and sales agreements with generation and distribution companies. The authorities will proceed with signed Memoranda of Understanding (MOU)s and adopt a formal rule requiring the regulator to use the BSTA to determine the cost-recovery tariff and government transfers by end-June 2024 **(proposed SB, reset)**.

25. Improvements in corporate governance and resolution of CPC and CEB legacy debt should reduce costs and bring down tariffs in a durable manner. In December 2023, the authorities eliminated the cross-debts between CPC, CEB, Sri Lankan Airlines (SLA) and the government. Nevertheless, substantial legacy debts also need to be addressed (Annex VIII). The authorities will adopt by end-December 2024 a repayment schedule for CEB debt starting April 2025 **(proposed SB)**. The electricity tariff calculation will start accounting for debt repayments starting January 2025. The dispatch audit of CEB's operational costs, planned for late 2024, would assess the scope for efficiency gains in electricity generation and transmission. Reforms to improve SOEs efficiency and governance should continue with support from development partners[17].

Authorities' Views

26. The authorities reiterated their commitment to the revenue-based fiscal consolidation and concurred with staff on prioritizing PFM reforms. Noting the legal and operational challenges of introducing the property tax, the MoF will expedite efforts to introduce the imputed rental income tax by early 2025. They will support IRD with additional resources to implement a VAT compliance improvement program and strengthen revenue collection from large taxpayers through improved digitalization. They maintained their commitment to repeal the SVAT by April 2025. They noted the economic and social costs of recent tax reforms while stressing the need for tax exemptions to attract foreign investment. They highlighted ongoing efforts to improve fiscal discipline through the upcoming PFM law and manage fiscal risks from SOEs.

B. Debt Sustainability

27. Advancing the debt restructuring, consistent with program parameters, is crucial. Sri Lanka's debt remains unsustainable pending the resolution of debt restructuring (Annex VII). The authorities have made significant progress in debt negotiations with external creditors. Staff has facilitated debtor-creditor engagement in line with Fund policies, by ensuring timely information sharing, and assessing consistency of debt treatment proposals with program parameters. Total debt relief, agreed and under negotiation, is expected to be consistent with program debt targets. However, post-restructuring debt sustainability risks will remain high (Annex II). An upcoming IMF working paper identifies policy slippages and external shocks as the root causes for Sri Lanka's debt problem and discusses the design of the restructuring strategy, with the aim to draw lessons for future restructurings[18].

28. The authorities have made progress with finalizing treatment with official creditors and reaching AIP with private creditors. The authorities are close to (i) agreeing on a MOU with the official creditor committee (OCC) and (ii) signed agreements with China EXIM Bank while continuing good faith negotiations with external bondholders and CDB to reach AIP soon.

29. Domestic financing needs and associated risks remain high in 2024. Net domestic financing is projected at 5.8 percent of GDP in 2024 due to a large fiscal deficit and limited external

[17] The WB, IFC, ADB, United States Agency for International Development (USAID), and others.

[18] Peter Breuer and Mike Li, "Sri Lanka's sovereign debt restructuring", upcoming IMF working paper.

financing.[19] With monetary financing prohibited, the government will continue to rely on domestic borrowing from banks and superannuation funds—the main institutional investors in Sri Lanka. With limited prospects of larger borrowing from superannuation funds, banks will invest more in government securities in 2024, potentially crowding out private credit. Growing bank balance sheets and a recovering economy are expected to mitigate these risks. Staff recommends that the authorities reduce borrowing needs from the market by partially using their cash buffer accumulated in 2023 to finance the deficit. Between 2025 and 2029, domestic financing is expected to decline to below 3 percent of GDP on the back of falling interest rates and deficits.

30. To prevent the risk of another debt crisis, the medium-term debt management framework needs to be strengthened promptly. Establishing the Public Debt Management Office (PDMO) by end-2024 and making it fully functional by end-2025 **(proposed SB)** are important initial steps. The authorities should move expeditiously towards a holistic debt management strategy, with forward-looking plans tied to annual and quarterly issuance, along with stronger communication to increase transparency and predictability. They are making good progress in advancing legal and institutional reforms on public debt management. With extensive support from IMF/WB TA, the Public Debt Management Act (PDMA) was submitted for Parliamentary approval on April 26, 2024. To curb fiscal risks from FX guarantees issued to SOEs, a ceiling will be introduced **(proposed IT)**. The implementing regulations of the PDMA will define guidelines for granting SOE guarantees and on-lending including clear processes, risk mitigation measures, strict eligibility criteria, and disclosure requirements. FX guarantees would be allowed on an exceptional basis to facilitate IFI financing to SOEs under very strict conditions.

Authorities' Views

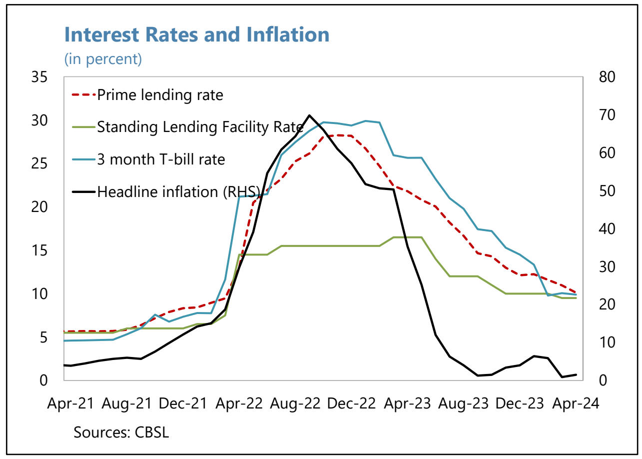
31. The authorities broadly agreed with the assessment of financing risks and staff's recommendations on domestic debt management. They are committed to reaching a swift resolution to debt restructuring discussions and restoring debt sustainability. While acknowledging domestic financing risks, the authorities are confident of their capacity to finance the deficit in 2024, after which the financing pressures should subside. They are dedicated to improving debt management strategy and practices, which should help lower the interest bills and ameliorate financing risks.

C. Monetary and Exchange Rate Policies

32. Monetary policy in Sri Lanka has responded to changing circumstances. Following the 2022 devaluation, the policy rate was hiked by a cumulative 900 basis points to facilitate an impressive disinflation path. As inflation fell, the policy rate was gradually reduced by 700 basis

[19] This excludes the banks' recapitalization amount of about 1.3 percent of GDP in 2024.

points between May 2023 and March 2024 to 9.5 percent (lending facility) to maintain price stability while supporting the recovery (Text figure). The CBSL communicated its commitment to remain prudent with respect to inflation risks from second-round effects of the new tax measures, wage increases, and re-emerging supply factors. Staff view the current monetary stance as broadly appropriate as confirmed by the Taylor Rule and the forward-looking real policy rate at around 2.5 percent (real neutral rate). 3-month T-bill and prime lending rates have declined by close to 20 percentage points from November 2022 to about 10 percent in April 2024 with narrowing risk premia, signaling easing financial conditions.



33. To safeguard the credibility of the inflation targeting regime, monetary policy should prioritize anchoring inflation expectations. A prudent and agile approach in formulating monetary policy is recommended. With inflation projected to exceed the CBSL target this year, the Taylor rule implies limited room for further loosening in the near team unless inflationary pressures subside faster than expected. Future monetary policy decisions should continue to be governed by the **MPCC** clause and a real policy rate path close to neutral. Interest rate caps have been eliminated, as committed in the MEFP (¶25), to improve monetary policy transmission and avoid credit distortions.

34. An important part of Sri Lanka's disinflation strategy is refraining from direct financing of the budget deficit and unwinding CBSL's large holdings of treasury securities. Monetary financing has been discontinued. The CBSL has maintained zero primary market purchases of government securities on a continuous basis **(continuous QPC)** and offloaded government securities in line with the NCG targets. While the CBSL remains committed to offload the T-bills, the NCG **(QPC)** level is expected to remain flat from September 2024 to March 2025 given limited marketability of the restructured bonds amid election and debt restructuring uncertainties. After market liquidity improves, the CBSL should continue to unwind the existing holdings of government securities, including the restructured bonds, to mitigate the sizable sterilization needs from reserve accumulation. Such operations can be supported by adequate central bank capitalization.

35. Adequate capitalization of the CBSL is critical to maintain its credibility and operational autonomy. Following the conversion of CBSL holdings of T-bills to T-bonds in September 2023 and the agreement to settle past due bills to the Asian Clearing Union (ACU) in October 2023, CBSL's equity dropped significantly from Rs. 728 billion in August 2023 to

Rs. 56 billion in March 2024.[20] Given the large holdings of illiquid restructured bonds and its negative net international reserve position, the CBSL's balance sheet remains vulnerable to FX and interest rate shocks. Rebuilding the capital position would enhance CBSL's credibility in conducting independent monetary policies without worrying about the impact on its capital. So far, the CBSL has been reluctant to seek a capital injection.

36. Continued exchange rate flexibility and reserve accumulation are critical to achieve program objectives and restore external buffers. Despite nominal exchange rate appreciation since early last year, the authorities have managed to accumulate reserves through outright purchases. The NIR target for June 2024 is revised up by US$100 million compared to the first review, locking in overperformance of reserve accumulation in 2023. The authorities committed to accumulate reserves further in line with the adjustment goals while allowing the exchange rate to adjust freely and limiting FX sales only to disorderly market conditions.

37. Relaxing the remaining administrative BoP measures would help facilitate the external adjustment. The authorities have developed an initial roadmap to relax restrictions on the importation of motor vehicles by 2025, starting with public passenger and special purpose vehicles in 2024 Q3, followed by goods transport vehicles in Q4 2024 and the rest in 2025. A detailed plan, including the implications on tax and reserve accumulations, will be finalized by June 15, 2024. They committed to develop a plan on removing the remaining administrative BoP measures, including exchange restrictions, Multiple Currency Practices (MCP), and capital flow measures (CFMs), by end-May 2024.[21]

Authorities' Views

38. The authorities remain committed to keep inflation contained and broadly agreed on the external sector assessment. They agreed to prioritize the objective to keep inflation expectations anchored and prohibit monetary financing by implementing an effective data-driven and forward-looking inflation targeting framework. However, they expressed difficulties in continuing to offload the restructured T-bonds before they mature in five years' time While in broad agreement on the external sector assessment, the authorities believe that partial external adjustment has already happened. In their view, the sensitivity of the trade balance to real effective exchange rate adjustment is weaker than assessed by staff; and they remain committed to maintain a flexible exchange rate regime.

[20] Although estimation approaches to valuing the restructured T-bonds differ between the IMF and CBSL due to technical challenges from the lack of a reliable yield-curve, these are largely acceptable as the resulting valuations do not differ significantly. The forward-looking stress test of CBSL balance sheet suggested capital needs of 0.5 percent of 2024 GDP to bring it to a robust capital position.

[21] Based on the reassessment following the new MCP policy, Sri Lanka maintains two MCPs: (i) the levy of a 2.5 percent stamp duty on credit card transactions abroad; and (ii) the levy of a 14 percent remittance tax on nonresidents' profits. Please see the Informational Annex for details. The CFMs that were described as active in IMF 23/408 Annex VII still remain.

D. Financial Policies

39. Sustained economic recovery hinges on efficient credit intermediation and financial deepening led by a healthy banking sector. A well-capitalized banking sector is critical to rebuild investor confidence, allow upgrading credit ratings, and boost credit growth. Banks that suffered from the debt restructuring, high NPLs and weak profit outlook should restore their capital position in a timely manner. However, a delay has been caused by the unfinished restructuring of CPC's FX loans. Projected bank capital shortfalls have been reduced since program approval by the more appreciated exchange rate, higher interest income for banks, the build-up of provisions, and better assumed restructuring terms on CPC's FX loans. The authorities have committed to bank recapitalization if needed to meet CBSL capital requirements. Forward-looking stress test buffers and other buffers above the regulatory requirements will not be included, but the CBSL will monitor banks' capital positions based on forward-looking stress tests and impose corresponding capital requirements, while the MOF would provide additional recapitalization funds as a last resort if shortfalls were to emerge in the future. The authorities should complete the restructuring of CPC's FX loans and the recapitalization of state-owned banks by August 2024 **(proposed SB)**. Private banks should implement their capital plan or be recapitalized in line with the authorities' strategy by December 2024 **(proposed SB)**. The suspension of banks' repossession of collateral ("Parate" executions)[22] will hinder the banks' ability to manage NPLs and price credit risks and should be lifted as soon as possible while encouraging a negotiated NPL solution to avoid excessive liquidation.

40. To prevent recurring financial sector vulnerabilities and improve efficiency, it is essential to enhance supervision and governance of state-owned banks. Parliament approved the Banking Act amendments on April 2, 2024, which strengthen the supervisory and regulatory standards on state-owned banks[23] and the Cabinet adopted and published a framework for their corporate governance on May 27, 2024 **(SB)**, requiring merit-based, independent, and transparent nominations for board and senior management. The CBSL will vet the selected personnel based on educational qualifications and professional experience.

Authorities' Views

41. The authorities acknowledged the importance of strengthening governance and capital positions of the state-owned banks. They are ready to meet the capital needs arising from debt restructuring by utilizing the related 2024 budgetary provisions. Given capital requirements in Sri Lanka that exceed the Basel minimum requirement by 200 bps (10 percent) and other capital buffers,[24] the authorities see no need to increase the capital level of state-owned banks beyond the regulatory minimum as excessive capital can be costly in the current juncture. They expect the banks

[22] This suspension is scheduled to end in December 2024.

[23] They include corporate governance, audit independence, and single exposure limits. External auditors have more independence and are held accountable in conducting and signing off their audit reports.

[24] Capital conservation buffer of 250 bps and Domestic Systemically Important Bang (D-SIB) buffer of 150/100bps depending on size of assets.

to improve their capital levels by accumulating profits as the economy recovers. They see modest impact based on the latest forward-looking stress tests[25] and expect banks to have the capacity to meet any additional capital needs on an ongoing basis without requiring future budget allocations.

E. Anti-Corruption and Governance Reforms

42. Comprehensive anti-corruption and governance reforms play a pivotal role in supporting the government's broader reform agenda and unlocking the growth potential. Staff analysis finds that comprehensive and coherent anti-corruption and governance reforms have the potential to improve economic outcomes, including enhancing revenue mobilization and public investment management while creating a conducive environment to promote private investments and facilitate other structural reforms (SIP). Steadfast implementation of the reforms recommended in the Governance Diagnostic Report, supported by meaningful civil society participation and government oversight, could significantly boost growth potential and reduce inequality. Following the enactment of the Anti-corruption legislation and the publication of the authorities' governance action plan, the next milestones are to ensure steadfast reform implementation:

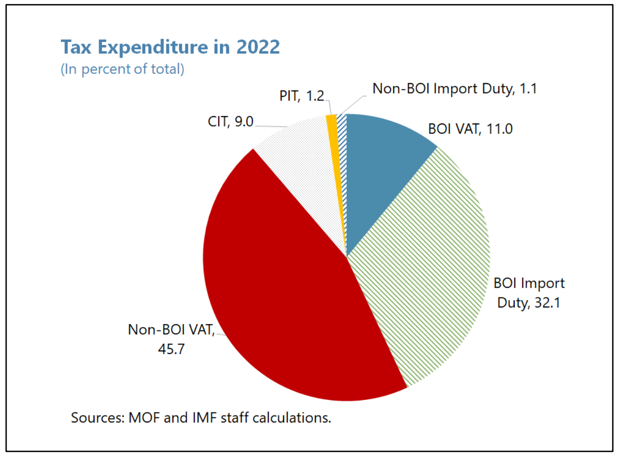
- **Anticorruption (AC) Legal Frameworks and Institutions**. To effectively fulfill its broadened mandate under the new Anti-corruption legislation, the Commission to Investigate Allegations of Bribery or Corruption (CIABOC) needs to be fully operationalized. The first step is for the CIABOC to publish a strategic plan, in consultation with the IMF, describing its mission, objectives, timebound actions for operations, and a monitoring framework, together with submission of CIABOC's annual budget (based on the new strategic plan), by October 2024 **(proposed SB)**.[26] In the meantime, the CIABOC remains committed to publish senior officials' asset declaration by end-July **(SB)** while working towards fully operationalizing the online asset declaration system. The Asset Recovery Bill, after much-needed public consultation, should be enacted by November 2024 (**proposed SB, reset**).

- **Tax policy**. Ad-hoc and non-transparent tax exemptions have been a major factor behind low tax revenues. The MoF estimates a total tax expenditure of 4.1 percent of GDP in 2022, equivalent to more than half of 2022 tax revenue (7.3 percent of GDP) and nearly half the envisaged revenue gains under the program during 2023-25 (Text figure).[27] While some VAT

[25] Conducted as of December 31, 2023.

[26] As articulated in Section 31 of the Anticorruption Act n.9.

[27] MOF, March 2024, Tax Expenditure Statement (treasury.gov.lk).



and CIT exemptions were removed recently, tax incentives under Strategic Development Projects (SDP) and Board of Investments (BOI) projects remain sizable (1.7 percent of GDP in 2022, MOF estimate) and imply a higher tax burden on non-exempt parties. The authorities committed to refrain from new tax exemptions, incentives, and from approving new projects under the SDP. They will submit amendments to the SDP Act introducing transparent, rules-based eligibility criteria for granting time-bound incentives to Parliament by end-February 2025 **(proposed SB)**.

- **Revenue Administration**. The authorities plan to reduce corruption vulnerabilities in revenue collection from taxes, excises, and customs. Each revenue department will develop an implementation plan to launch a program of anti-corruption measures to strengthen Code of Conduct, Internal Affairs department, risk management and automation by August 2024 **(proposed SB)**.

- **PFM**. The semi-annual updates of the publication of procurement contracts, the list of firms receiving tax exemptions, and the value of all exemptions, are planned for June and December 2024 **(SB)**. Other PFM reforms are described in MEFP ¶34.

- **Public Asset Oversight and Management**. To enhance transparency and accountability in managing public assets, the authorities will (i) study the options to establish and publish a government policy on criteria for allocating rights to public assets**,** with clear requirements for transparency, competition, and information provision to the public and a timeline to bring existing laws and regulations in compliance with the policy; and (ii) amend the National Audit Act by September 2024 to enable the Auditor General to levy fines on officials, including Chief Accounting Officers, who fail to fulfill their responsibilities in overseeing and managing the public assets.[28]

- **AML/CFT**. Following the publication of National AML/CFT Risk Assessment (NRA) report and the approval of the AML/CFT National Policy (2023-2028) in 2023, the authorities will continue to strengthen the AML/CFT regime, including introducing amendments to the legal framework, conducting AML/CFT risk-based supervision, strengthening the use of financial intelligence and cooperation between FIU, law enforcement, and the CIABOC. They will amend the Company Act to bring the beneficial ownership framework in line with the FATF standards by September 2024.

[28] The Attorney General does not have the authority to dismiss officials and mechanisms to do so are complex and difficult.

At the same time, it will be important to maintain the civic space needed for civil society organizations to operate.

Authorities' Views

43. **The authorities are motivated to reap the benefits from the governance reforms and are committed to sustain their ongoing efforts, but they point out some challenges of these reforms**. The authorities acknowledged corruption vulnerabilities associated with tax exemptions and agreed to maintain transparency on tax expenditures. The CIABOC would like to expedite its full operationalization but is constrained by the existing capacity and financing resources. They requested technical assistance from the IMF and other international partners. The authorities highlighted efforts to improve fiscal transparency and commitment to tackle corruption across revenue agencies. While understanding the importance of establishing a government policy to manage public assets with enhanced transparency, the authorities would like to study various implementable options before committing to the specific policies.

F. Inclusive and Growth-Enhancing Structural Reforms

44. **Sri Lanka inherited long-standing structural impediments that hindered its growth potential**. Productivity, investments, and employment growth stagnated reflecting the impact of the crisis and profound resource misallocation[29]. Sri Lanka's highly protective trade regime inhibited import competition, export diversification, and foreign direct investment. The labor force participation (LFP) rate has fallen significantly while female LFP remained persistently low (Text chart, Annex VII). Private sector growth, especially for SMEs, has been impeded by limited credit and land access, administrative restrictions, and inefficient energy supply. The crisis underscored substantial scope to improve the efficiency in the SOE sector.

45. **To support the post-crisis recovery and boost long-term growth, structural reforms need to be prioritized and strategically phased in**. The authorities took initial steps on important structural reforms related to trade openness, labor market flexibility, female labor force participation, and governance. They drafted the National Policy on Economic Transformation Bill that outlines the economic objectives that need to be achieved through comprehensive reforms over the longer-term horizon. Ongoing reforms need to be deepened and phased in more systematically, with support from international development partners.

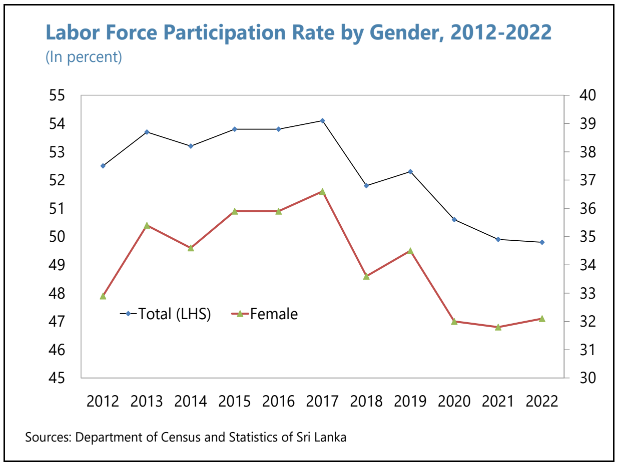
- **Trade**. The authorities committed to reducing the para-tariffs under the WB's Development Policy Operation (DPO).[30]. More trade reform initiatives are underway including updating the National Export Strategy, expediting trade agreements, participating in global value chains, and

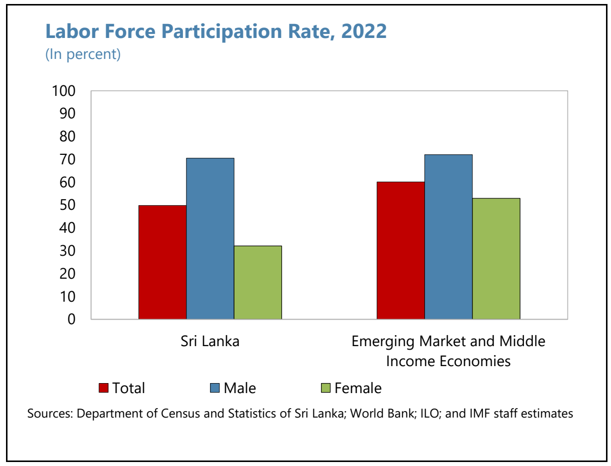
[29] World Bank, 2013, "Sri Lanka Resilience, Stability and Economic Turnaround Development Policy Operation", P179808.

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

promoting tourism. The authorities should consider streamlining the restrictive and cumbersome investment regime, for example through fully implementing a national single window for investors. Steadfast implementation of these initiatives is critical to realize the economic benefits.

- **Labor market**. The proposed Employment Act is a positive step towards unifying and modernizing existing labor laws to address labor market rigidities, gender gaps in employment, and low labor force participation (LFP) (Annex VII). The new Act will introduce measures to promote female LFP, notably the relaxation of restrictions on night-work for women and updating provisions related to occupational safety, health, and welfare of employees. Beyond legislative reforms, further steps to improve female LFP could include expanding childcare facilities, safe transportation for women, and introducing gender-responsive budgeting.





- **Electricity sector reform**. Following the adoption of cost-recovery tariff adjustment, structural reforms in the electricity sector should be pursued with technical support from development partners to reduce Sri Lanka's high electricity cost and address large investment needs in generation and transmission. These reforms will facilitate financing of renewable energy projects, which would strengthen competition in the energy sector and put further downward pressure on costs.

- **SOEs and private sector**. Improving SOEs' governance and efficiency is important to promote efficient resource reallocation, foster competition, and boost productivity (Annex IX). Reforms that promote a level playing field for private firms and upgrade labor skills are essential to improve competitiveness, facilitate greater integration into the global value chain (e.g., SMEs' role as domestic suppliers or service providers) and encourage formalization of the informal firms. Further, adopting digital technology supports productivity gains in both SOE and private sectors.

- **Climate change**. Given emerging climate vulnerabilities, Sri Lanka should strengthen mitigation efforts, including through contingency budgeting and insurance schemes for natural disasters.

Authorities' Views

46. **The authorities agreed with staff assessment of the structural impediments and are committed to growth-enhancing structural reforms**. They welcomed staff analysis that quantifies the economic gains of governance and other structural reforms. The authorities sought support from the IMF and other international development partners in areas including strategies to promote foreign direct investment and climate change reform agenda.

PROGRAM MODALITIES AND MONITORING

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

48. **Modifications of program targets and new SBs are proposed to strengthen the safeguards for program risks in the run-up to the election**.

- Staff proposes a higher NIR target for end-June 2024 to lock in the overperformance from 2023 and early 2024. Accelerating reserve accumulation when market conditions allow helps build the buffer to weather election uncertainties and the implications of relaxing import restrictions. The program request included an MEFP commitment to prohibit the issuance of FX guarantees to SOEs, which is now being relaxed to allow non-financial SOEs to access IFI financing. To limit fiscal risks, staff proposes a new IT ceiling on FX guarantees starting from September 2024.

- The PFM SB from the first review is upgraded to prior action to ensure timely implementation. New SBs are proposed to seek the parliamentary approval of revenue measures for the 2025 Budget ahead of the presidential elections (¶17) and expedite the preparatory work needed to introduce the imputed rental tax and implement the 2025 revenue measures. The reporting of the quarterly SBs on the KPIs is postponed by two months after each quarter to allow the authorities time for data preparation. Other new and reset SBs are summarized in the MEFP.

49. **Staff assesses that the progress made in restructuring Sri Lanka's debt is consistent with restoring its medium-term external viability and safeguarding its capacity to repay the Fund, and the program is fully financed.** There are firm commitments of financing for the next twelve months and good prospects for adequate financing during the program period. Program financing gaps in 2024-27 are expected to be filled through debt restructuring and new financing. AIPs with the main official creditors (¶28), and the consent received from Saudi Arabia, Kuwait, Iran, and Pakistan, to which Sri Lanka continues to have arrears, are in line with Lending into Official Arrears (LIOA).[31] Consistent with the Lending into Arrears (LIA) policy, the authorities are making

[31] Sri Lanka's debts to Chinese commercial creditors, insured by SINOSURE, have been categorized as commercial debt in line with the member's representation.

good faith efforts on debt restructuring with remaining private creditors (external bondholders, CDB and others) and are pursuing appropriate policies consistent with the EFF program. They are engaged in significant efforts to facilitate information sharing between the official creditors to agree on a MOU with the OCC and sign the final agreement with China EXIM Bank. With all these elements, the completion of the financing assurances review is recommended. Going forward, Sri Lanka is expected to reach AIPs with bondholders and CDB in line with program parameters, reach agreement on the MOU with the OCC and secure signed agreement with China EXIM before the completion of the third review. Firm assurances from the WB and ADB have been received regarding 2024-2025 financing, with good prospects for IFI financing in the rest of the program period. Total non-IMF IFI program financing envelope amounts to US$3.8 billion over the program period.

50. The Fund continues to face enterprise risks. First, financial risks arise from the capacity to repay and prolonged debt restructuring which suggests that credit risks to the Fund could extend beyond the program period (¶40). Second, business and reputational risks stem from waning public support for reforms ahead of the elections and after the conclusion of the debt restructuring. Buffers from program overperformance at end-December help to mitigate program performance risks in 2024. Key measures to sustain the reform momentum include the authorities' firm commitment to the reform agenda and timely conclusion of the debt restructuring; upfront implementation of reform measures including on anti-corruption; adjusting conditionality to evolving circumstances; and extensive Capacity Development (CD) support to ensure timely delivery of program reforms (Annex IX). Weekly program monitoring meetings with the authorities help to ensure timely implementation of the reforms and meeting the targets under the program and. Steadfast implementation of structural reforms and coordination with other multilateral donors on adequate and timely disbursement of budget support and project financing should help boost confidence and growth and mitigate risks from debt restructuring and capacity to repay.

51. Safeguards Assessment (SA). Since the February 2023 update, a new Central Bank Act was enacted incorporating SA recommendations, financial risk management was expanded, and steps were initiated to strengthen the internal audit function, including the completion of an external quality assessment. [32] However, in view of the CBSL's weakened equity and the TA received on assessing its balance sheet and monetary operations, the SA recommended that the CBSL approves a medium-term plan to strengthen its financial position. Staff will continue to engage with the CBSL on the implementation of remaining recommendations.

[32] The updated assessment found that the CBSL's audit and financial reporting functions meet international standards, and the internal control environment is anchored in a strong compliance culture; however, some functions require continued modernization.

External Financing Gap and Program Financing, 2022-2027
(in millions of US dollars)

	2022	2023	2024	2025	2026	2027	Total 2022-27
Financing Gap (A)	-2,834	-5,670	-4,621	-4,800	-3,206	-4,400	-25,532
Program Financing (B)	2,834	5,670	4,621	4,800	3,206	4,400	25,532
IMF EFF	0	678	679	682	683	342	3,064
IFI program financing support	0	1,220	768	740	558	550	3,836
World Bank*	0	570	368	270	258	250	1,716
ADB	0	650	400	470	300	300	2,120
Other	0	0	0	0	0	0	0
Debt moratorium: external arrears accumulation	2,834	3,772	0	0	0	0	6,606
Debt relief	0	0	3,174	3,378	1,965	2,008	10,526
Sovereign bonds (market access)	0	0	0	0	0	1,500	1,500
Shortfall (A+B)	0	0	0	0	0	0	0
Memorandum:							
Gross International Reserves	*1,898*	*4,387*	*5,605*	*7,174*	*9,262*	*13,466*	
Project loans	*1,473*	*680*	*1,000*	*1,556*	*1,603*	*1,651*	

Source: CBSL and IMF Staff Projections
** World Bank CY 25-27 figures are indicative as WB CPF will be reviewed in FY 2025, and the size of IDA 21 is unknown. An additional $135 million disbursment from the WB on deposit insurance is not included in program financing, as it will be ringfenced.*

52. Capacity to repay the Fund. Capacity to repay the Fund (Table 7), while adequate under the program scenario, is subject to significant risks and contingent on the successful implementation of program measures and debt restructuring that restores debt sustainability. Under the program, Fund credit outstanding would peak at 3.2 percent of GDP in 2027, corresponding to 13.4 percent of exports of goods and services and 22.5 percent of gross reserves. EFF repurchases and charges would peak in 2031, at 2.5 percent of exports of goods and services and 3.8 percent of gross reserves.

53. Article VIII. The authorities have not (i) introduced additional measures giving rise to new MCPs or exchange restrictions; or (ii) modified/intensified existing exchange restrictions and MCPs subject to Fund Approval under Article VIII; or (iii) concluded bilateral payment agreements that are inconsistent with Article VIII of IMF Articles of Agreement; or (iv) imposed or intensified import restrictions for balance of payments purposes. The authorities are seeking temporary approval of the remaining exchange restrictions and MCPs.[33]

[33] This includes MCPs considered as new under the updated MCP policy.

54. Capacity Development. Sri Lanka's CD strategy is anchored on the key program objectives of revenue mobilization, public financial management, public debt management, monetary operations, financial sector supervision and regulation, macroeconomic frameworks and financial programming, governance, and data compilation. CD has supported the implementation of past IMF staff advice, which gained good traction (Annex IX).

55. Data Issues. Macroeconomic statistics are broadly adequate for surveillance. The main data gaps, including GDP data by expenditure components, and potential CD support needed to improve data quality are shown in Annex X.

STAFF APPRAISAL

56. Reforms and policy adjustment are bearing fruit with the economy starting to recover, but vulnerabilities remain. The economy is stabilizing, including contained inflation, reserves accumulation, improved revenue collection and fiscal performance. However, pockets of vulnerabilities associated with the ongoing debt restructuring, revenue mobilization, banks' capital position, and reserve accumulation momentum continue to cloud the outlook.

57. Program performance has been strong, though risks are rising ahead of the elections. All quantitative targets were met, except for the IT on social spending, which was missed by a small margin due to operational challenges in resolving a large number of grievances. All continuous SBs and ten out of fourteen other SBs were either met or implemented with a delay. One reprogramed SB on the Banking Act amendment was implemented on April 2. The PFM law SB is upgraded to a PA. The operationalization of BSTA is expected to be finalized by end-June and the delayed enactment of asset recovery bill will allow much needed public consultations. Despite the strong commitment of the current government, program risks, especially in the fiscal area, are high in the run-up to the elections, which are mitigated by strong safeguards and contingency planning.

58. Restoring fiscal and debt sustainability requires sustained revenue consolidation and finalization of debt restructuring. Notwithstanding the good fiscal performance in 2023, sustained revenue mobilization efforts remain crucial to meet program targets and restore and maintain fiscal sustainability in the medium-term. A commitment to revenue administration reforms is a pre-requisite to improve compliance, especially from large taxpayers. PFM reforms are key to reinstate fiscal discipline and curb fiscal risks from SOEs. Meeting the revenue targets is necessary to ensure that the government is able to meet all essential spending, including social and capital expenditure. Current tax exemptions are of macro-critical proportions and suppress revenue to low levels compared to historical values. They also require correspondingly higher tax contributions from non-exempt parties including individuals and small businesses, and any further exemptions should only be granted in exceptional circumstances following the elaboration of transparent, rules-based eligibility criteria. Finalizing the debt treatment remains crucial to restore debt sustainability and rebuild investor confidence.

59. Monetary and exchange rate policy should continue to bolster macroeconomic rebalancing. Maintaining price stability remains the top priority for the monetary policy, which requires prudent and agile monetary policy and continued commitment to prohibit monetary financing. Gradually phasing out the BoP restrictions and continuing with exchange rate flexibility would facilitate rebalancing the external positions and rebuilding external buffer.

60. Sri Lanka's external position is assessed as moderately weaker than implied by medium term fundamentals and desirable policies, highlighting the need for further external adjustment. The 2023 current account surplus, adjusted for cyclical and temporary factors (including the moratorium on interest payments), reflects an underlying structural deficit (of around 0.6 percent of GDP), which should be brought down to a more sustainable level (surplus of 1 percent of GDP) (Annex VI). Pursuing fiscal consolidation, exchange rate flexibility, and further reserve accumulation will support the progress towards attaining a sustainable external position.

61. Strengthening financial sector resilience would help support the economic recovery. The authorities should focus on restoring banks' capital positions by expediting recapitalization for the banks that suffered from the debt restructuring and revealed vulnerabilities in the AQR exercises. The governance and oversight frameworks for state-owned banks need to be strengthened to ensure financial resilience and contribute to efficient credit intermediation and financial deepening.

62. Implementing comprehensive governance reforms is critical to enhance program performance and boost growth potential. Revenue-based consolidation efforts can be reinforced by efforts to combat corruption and boost compliance from taxpayers. When implemented in a coherent manner, anti-corruption, and governance reforms help reduce resource misallocation and improve business environment that foster inclusive and sustainable growth.

63. Prolonged structural challenges need to be addressed to unlock Sri Lanka's long-term potential. Despite ongoing efforts and initiatives to promote trade, improve female labor force participation, and restructure the SOE sector, more comprehensive reform plans are needed. Prioritization should be given to further liberalize trade, improve investment climate, reduce gender gap, improve SOE efficiency, create a level playing field for the private sector, and mitigate climate vulnerabilities. Support from international development partners remains important to facilitate the prioritization and implementation of these reforms.

64. Based on Sri Lanka's overall strong performance and commitments under the program, staff supports the authorities' request for the completion of the Second Review. Staff supports the requests for (i) resetting two SBs to a later date, (ii) the modification of end-June 2024 performance criterion and introduction of an indicative target, and (iii) the completion of the financing assurances review. Staff also supports the authorities' request for temporary approval of existing exchange restrictions and new MCPs, as the approval criteria are met.[34]

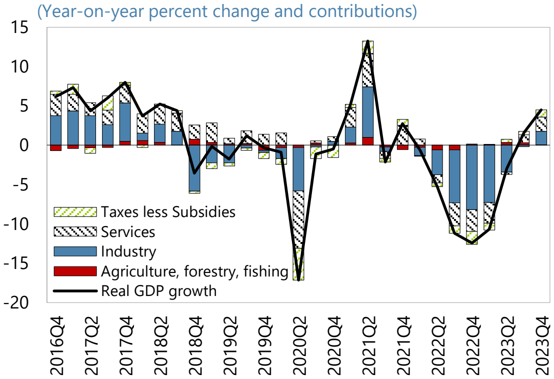
[34] These restrictions are imposed for BOP reasons, are non-discriminatory, and temporary in nature.

65. It is expected that the next Article IV consultation with Sri Lanka will be held in accordance with the Executive Board decision on consultation cycles for members with Fund arrangements.

Figure 1. Sri Lanka: Real Sector

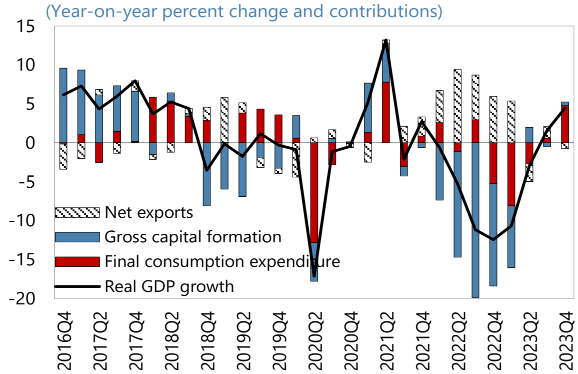
Real growth in 2023 was supported by broad recovery across sectors…

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



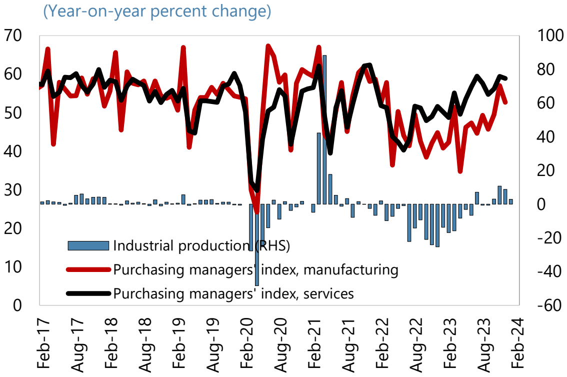
… with stronger household consumption and private investment momentum.

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



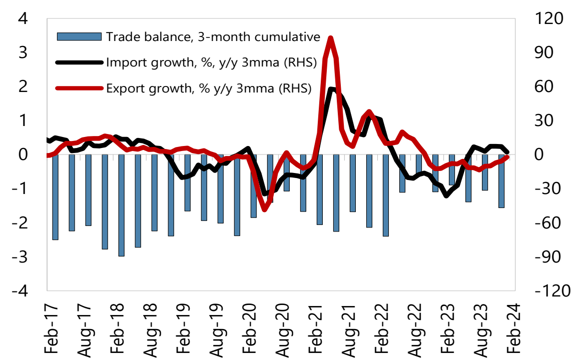
High frequency indicators point to continue expansion in 2024.

Economic Activity
(Year-on-year percent change)



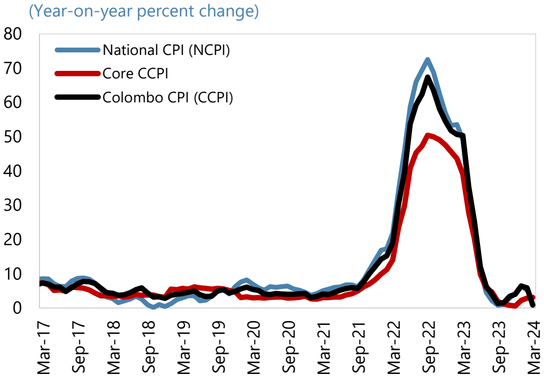
Trade remains weak with continued import compression and sluggish exports.

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



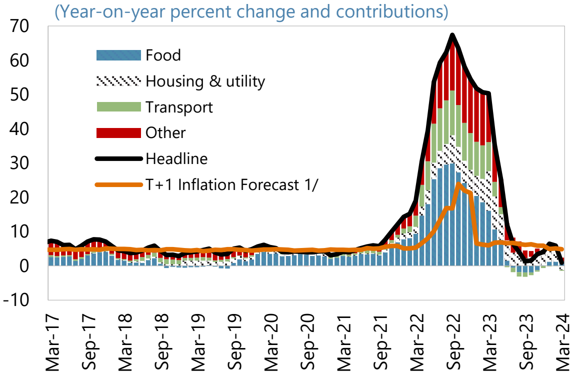
Inflation remains low…

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



… due to limited second round effect from tax measures and base effects.

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

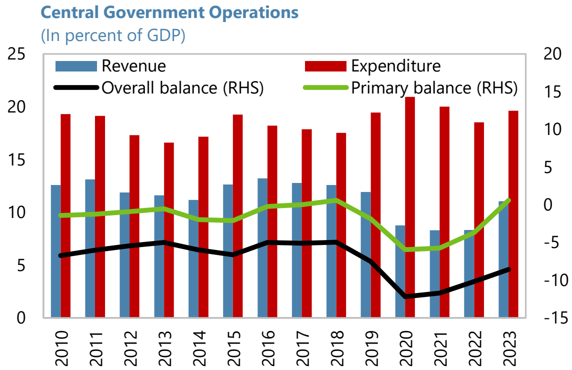


Sources: CBSL; and IMF staff calculations.

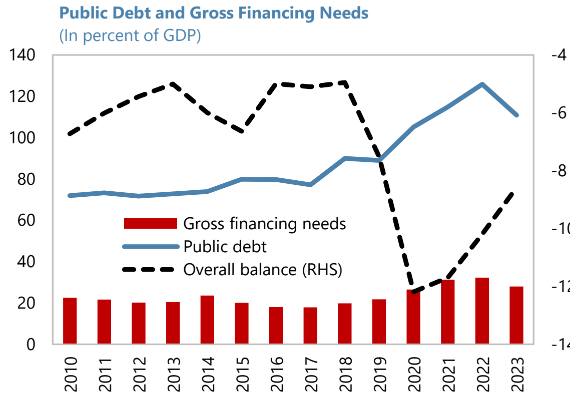
1/ T+1 Inflation Forecast is sourced from the IMF Consensus Forecast Database.

Figure 2. Sri Lanka: Fiscal Sector

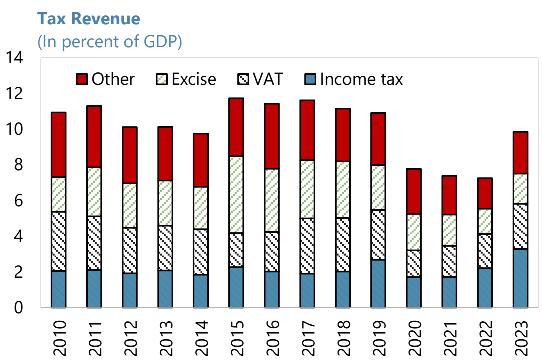
Amid the recession, tax revenue increases and primary spending restraint delivered a primary surplus.



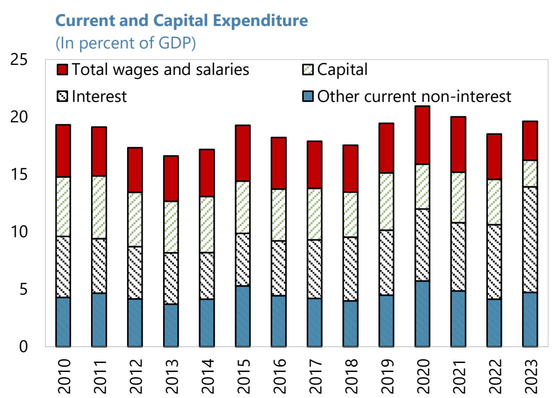
Public debt and gross financing needs remain elevated.



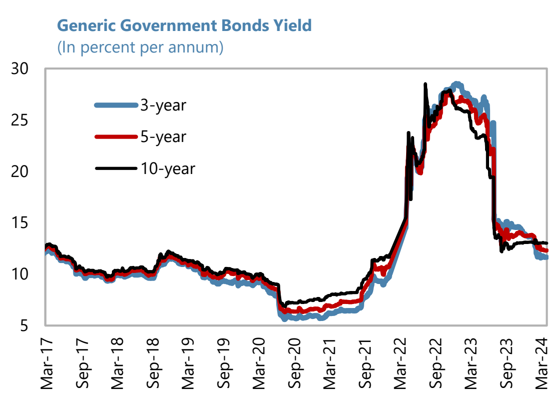
Tax collections were driven by improved income taxes and other indirect domestic taxes…



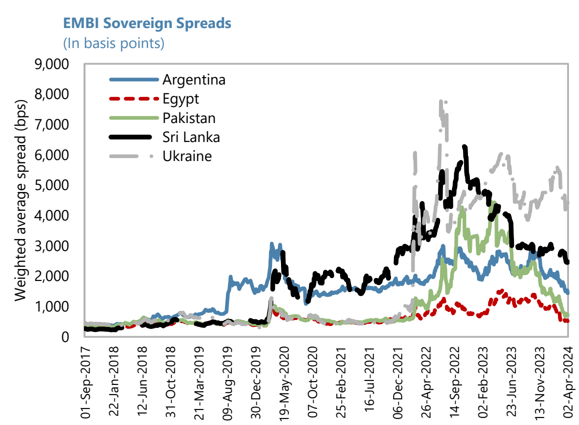
…but interest payments are large and increased.



Local currency yields have declined and are approaching historic average levels…



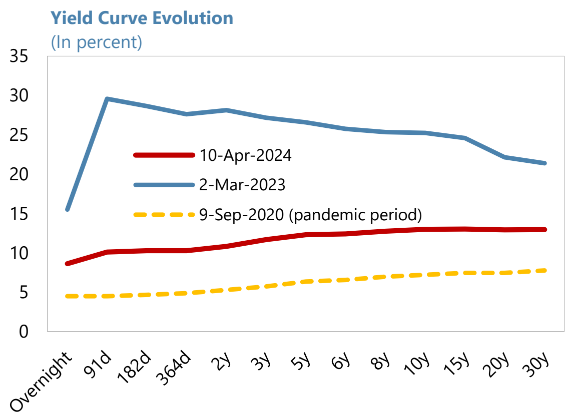
…and Sri Lanka's Emerging Markets Bond Index (EMBI) spreads continued to decline but remain high



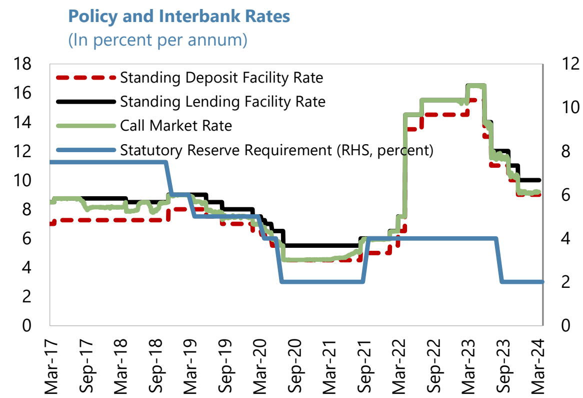
Sources: CBSL; Ministry of Finance; Bloomberg Data L.P.; and IMF staff calculations.

Figure 3. Sri Lanka: Financial Market

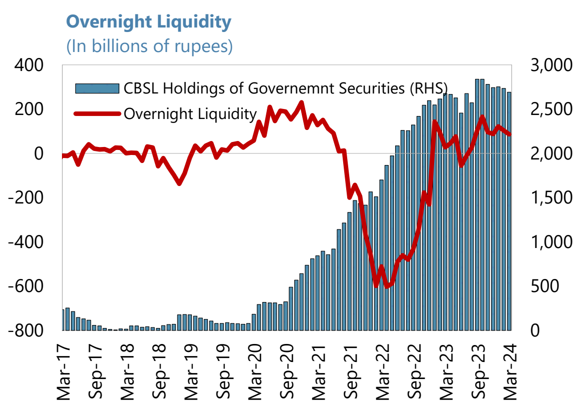
Yield curve shifted down substantially and normalized to positive slope…



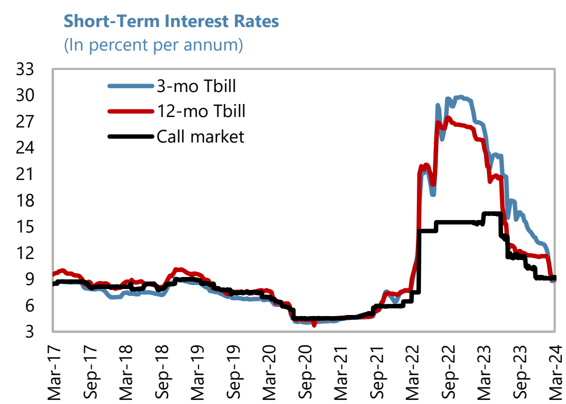
…as policy rate was cut a few times to below 10%…



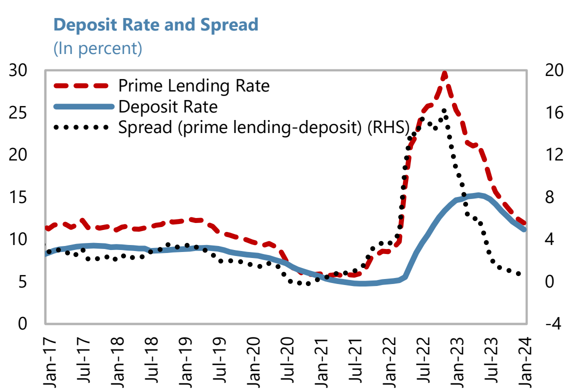
…and market liquidity improved with FX inflows.



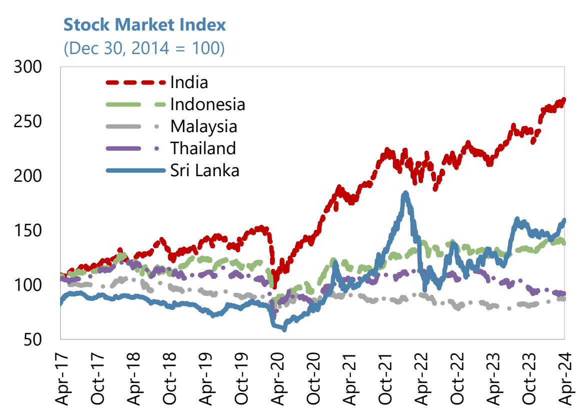
Market rates of T-bills moved close to policy rate amid compression of sovereign risk premium.



Lending rates dropped faster than the deposit rates to push the spread back to long-term average.



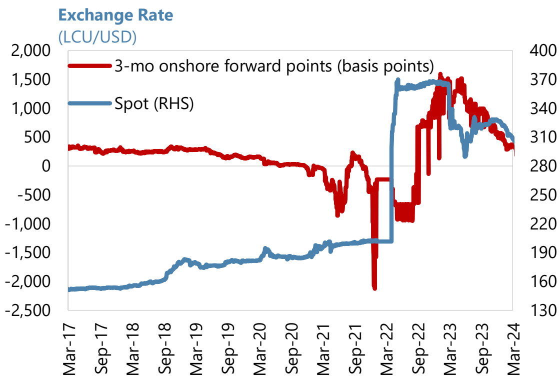
Equity market recovered from the crisis and held up well.



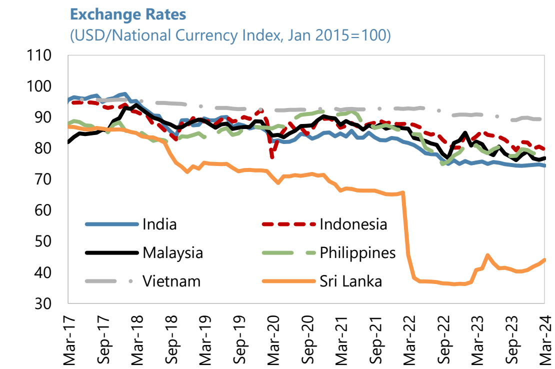
Sources: CBSL; CEIC Daily Database; Bloomberg Data L.P.; and IMF staff calculations.

Figure 4. Sri Lanka: Foreign Exchange and Reserves

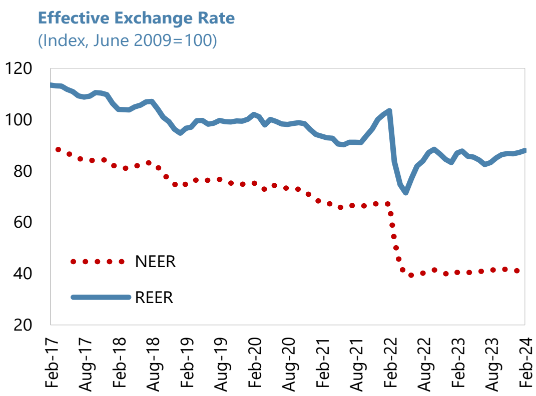
The rupee has appreciated in recent months, reflecting improving domestic FX liquidity …



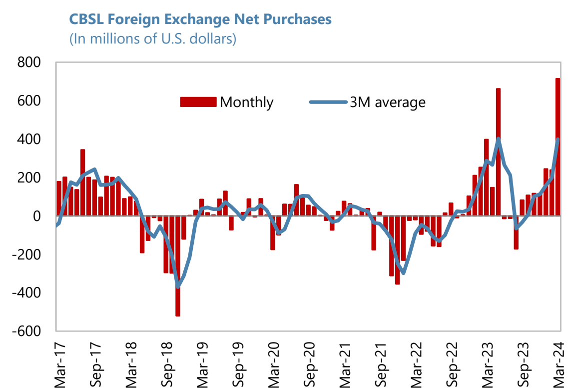
…even as other currencies in the region remained stable or marginally weakened…



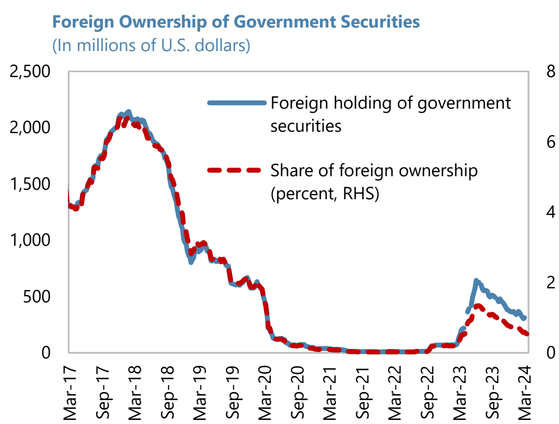
…leading to a REER appreciation as domestic inflation declined too.



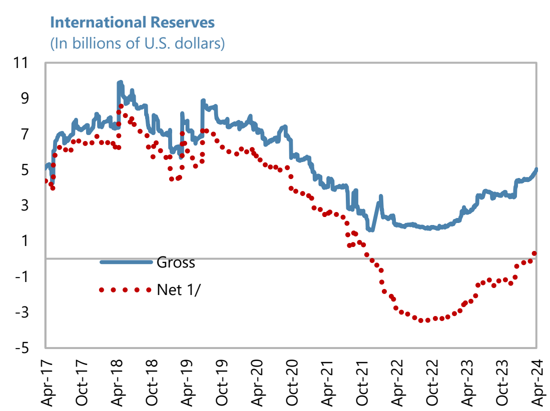
The improved FX market conditions have allowed the CBSL to accumulate reserves through net purchases…



…despite the recent drop in foreign holdings of domestic securities, partly due to declining yields…



…resulting in an improved official reserve position



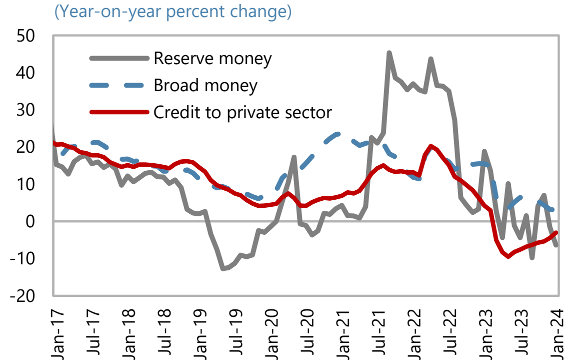
Sources: CBSL; CEIC Data Company Limited; Bloomberg Data L.P.; and IMF staff calculations.

1/ NIR numbers as per CBSL definition.

Figure 5. Sri Lanka: Monetary and Financial Sector

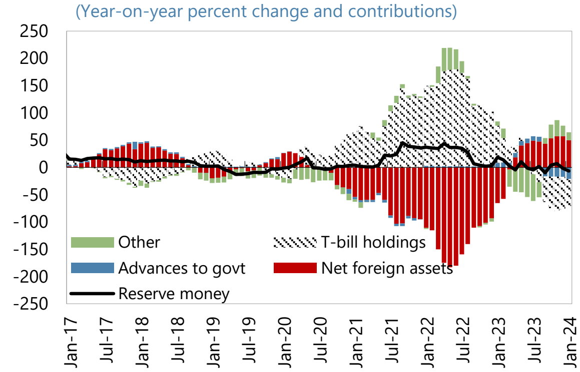
The growth of private credit and monetary aggregates remains anemic

Monetary Aggregates
(Year-on-year percent change)



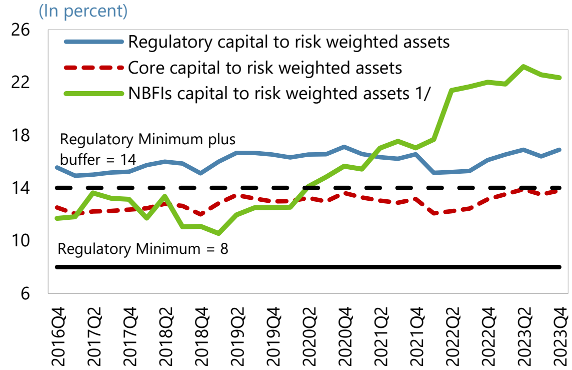
Reserve money growth was lackluster as decumulation of T-bills roughly offset FX reserve accumulation

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



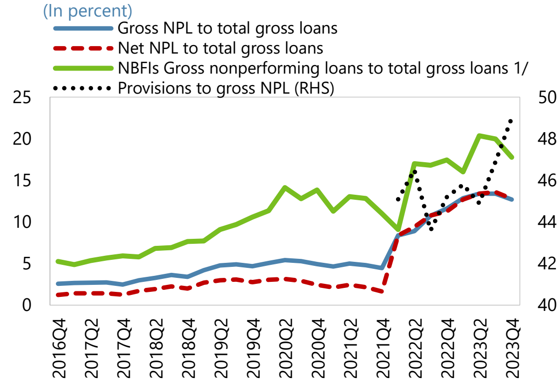
Reported capital levels are high before accounting for the full impact of ongoing debt restructuring

Capital Adequacy of Banking Sector
(In percent)



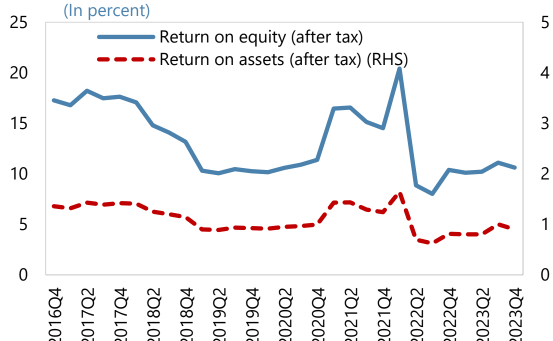
NPLs remained elevated, and provisions increased in 2024

Non-performing Loans of Banking Sector
(In percent)



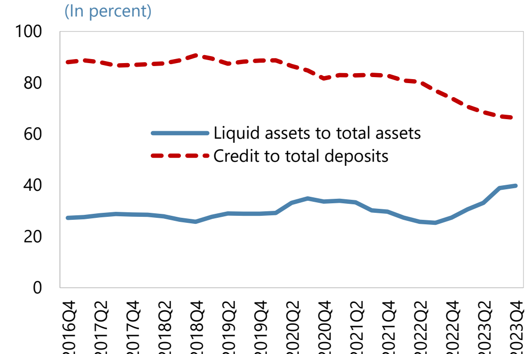
the profit outlook diminished on shrinking net interest rate margin and weak credit growth…

Profitability of Banking Sector
(In percent)



…but the banking sector liquidity improved due to more investment in government securities

Liquidity of Banking Sector
(In percent)



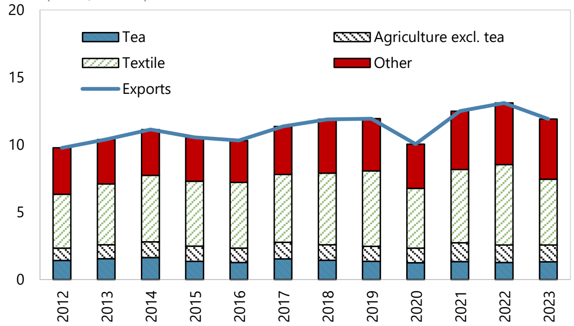
Sources: CBSL; and IMF staff calculations.

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

Figure 6. Sri Lanka: Balance of Payments

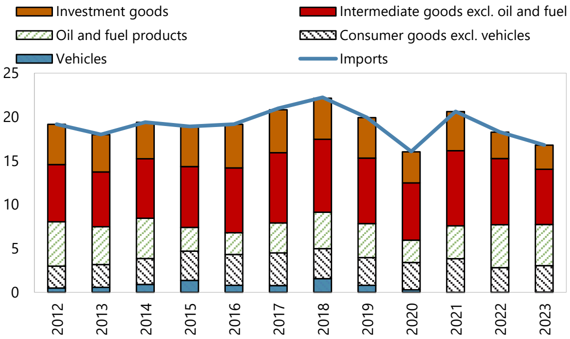
While Sri Lanka's goods exports declined, in part due to reductions in apparel exports....

Exports of Goods
(In US$ billions)



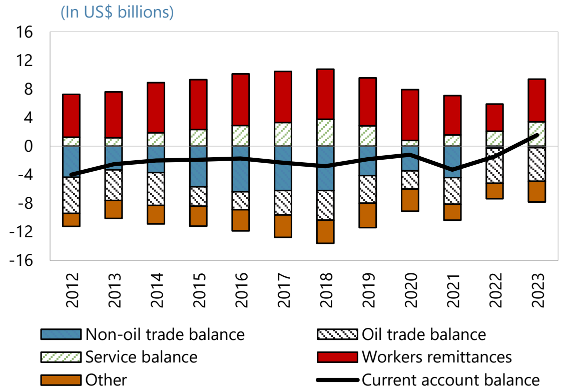
.... imports fell by a larger margin, reflecting continued import restrictions...

Imports of Goods
(In US$ billions)



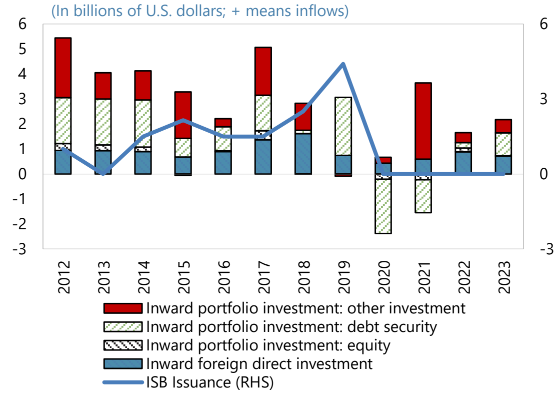
.... contributing to a positive current account balance for the first time in over two decades.

Current Account
(In US$ billions)



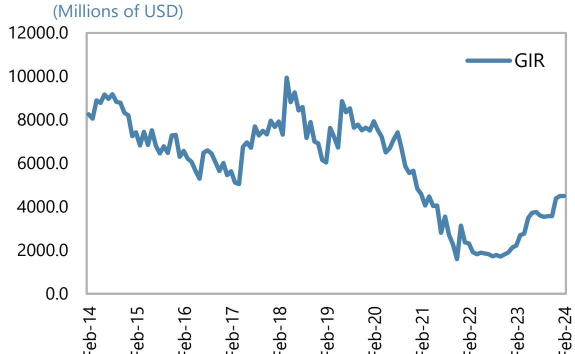
Direct and portfolio Investment flows slowly picked up in 2023....

Financial Account
(In billions of U.S. dollars; + means inflows)



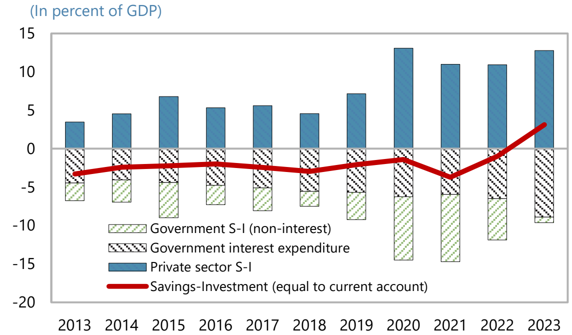
...and Gross International Reserves increased due to large net FX purchases by CBSL.

Foreign Reserves
(Millions of USD)



The improved current account balance in 2023 was supported by increased net savings by the private sector and fiscal consolidation by the public sector.

Savings-Investment Balance by Sector
(In percent of GDP)



Sources: CBSL; and IMF staff calculations.

Table 1. Sri Lanka: Selected Economic Indicators, 2021–29 (Restructuring Scenario)

	2021	2022	2023	2023	2024	2024	2025	2026	2027	2028	2029
	Act.		First Review	Prel.	First Review	Proj.	Proj.				
GDP and inflation (in percent)											
Real GDP growth	4.2	-7.3	-3.6	-2.3	1.8	2.0	2.7	3.0	3.1	3.1	3.1
Inflation (average) 1/	6.0	45.2	17.9	17.4	7.9	7.0	5.8	5.4	5.2	5.1	5.0
Inflation (end-of-period) 1/	12.1	54.5	4.8	4.0	6.6	6.9	5.5	5.4	5.2	5.1	5.0
GDP Deflator growth	8.0	47.5	20.4	17.5	10.1	9.8	6.9	5.4	5.2	5.1	5.0
Nominal GDP growth	12.6	36.6	16.1	14.8	12.1	11.9	9.8	8.5	8.5	8.3	8.3
Savings and investment (in percent of GDP)											
National savings	33.0	27.6	31.8	33.9	30.8	32.5	31.0	31.3	31.9	31.8	31.8
Government	-7.3	-6.4	-6.0	-6.0	-3.1	-3.4	-1.0	-0.1	0.3	0.7	0.7
Private	40.4	34.0	37.8	39.9	33.9	35.9	31.9	31.4	31.6	31.1	31.0
National Investment	36.7	28.6	30.3	30.8	31.6	32.1	32.1	32.4	32.8	32.7	32.6
Government	7.4	5.5	4.1	3.7	5.1	5.0	5.1	5.2	5.1	5.2	5.2
Private	29.4	23.1	26.2	27.1	26.5	27.1	27.0	27.3	27.7	27.5	27.4
Savings-Investment balance	-3.7	-1.0	1.5	3.1	-0.8	0.5	-1.1	-1.2	-0.9	-0.9	-0.8
Government	-14.7	-11.9	-10.1	-9.6	-8.2	-8.4	-6.0	-5.3	-4.8	-4.5	-4.4
Private	11.0	10.9	11.6	12.8	7.5	8.8	4.9	4.1	3.9	3.6	3.6
Public finances (in percent of GDP)											
Revenue and grants	8.3	8.4	10.2	11.1	13.0	13.6	15.1	15.3	15.4	15.4	15.4
Expenditure	20.0	18.6	19.0	19.4	20.3	20.9	20.3	19.9	19.5	19.2	19.2
Primary balance	-5.7	-3.7	-0.7	0.6	0.8	1.0	2.3	2.3	2.3	2.3	2.3
Central government balance	-11.7	-10.2	-8.8	-8.3	-7.3	-7.3	-5.2	-4.6	-4.1	-3.8	-3.8
Central government gross financing needs	31.0	34.1	27.8	27.8	25.3	24.9	23.7	20.5	16.6	13.1	11.9
Central government debt	102.7	115.9	107.8	109.8	110.3	108.8	108.4	108.3	106.6	103.2	100.1
Public debt 2/	114.8	126.3	114.1	115.7	115.9	114.2	113.1	112.5	110.2	106.5	103.1
Money and credit (percent change, end of period)											
Reserve money	35.4	3.3	9.0	-1.5	16.9	18.8	11.0	8.5	8.5	8.3	8.3
Broad money	13.2	15.5	7.0	7.3	18.2	14.9	10.4	8.5	8.5	8.3	8.3
Domestic credit	19.5	18.8	5.5	-1.2	10.6	9.3	3.6	2.5	2.3	2.4	6.7
Credit to private sector	13.1	6.4	0.3	-0.8	7.7	7.2	9.2	9.3	9.5	9.4	9.3
Credit to private sector (adjusted for inflation)	7.2	-38.8	-17.6	-18.2	-0.2	0.2	3.4	4.0	4.3	4.3	4.3
Credit to central government and public corporations	26.5	31.1	9.8	-1.6	12.8	11.0	-0.9	-3.4	-4.7	-5.5	3.2
Balance of payments (in millions of U.S. dollars)											
Exports	12,499	13,106	12,365	11,911	13,555	12,913	13,624	14,261	14,903	15,591	16,384
Imports	-20,638	-18,291	-17,887	-16,811	-20,718	-20,059	-22,565	-23,706	-24,362	-25,255	-26,363
Current account balance	-3,285	-744	1,232	2,644	-634	412	-926	-1,031	-804	-819	-840
Current account balance (in percent of GDP)	-3.7	-1.0	1.5	3.1	-0.8	0.5	-1.1	-1.2	-0.9	-0.9	-0.8
Current account balance net of interest (in percent of GDP)	-2.1	0.1	2.9	4.3	1.2	2.8	1.3	1.1	1.5	1.6	1.5
Export value growth (percent)	24.4	4.9	-5.7	-9.1	9.6	8.4	5.5	4.7	4.5	4.6	5.1
Import value growth (percent)	28.5	-11.4	-2.2	-8.1	15.8	19.3	12.5	5.1	2.8	3.7	4.4
Gross official reserves (end of period)											
In millions of U.S. dollars	3,139	1,898	3,806	4,387	5,346	5,605	7,174	9,262	13,466	15,105	15,286
In months of prospective imports of goods & services	2.0	1.2	2.0	2.4	2.6	2.7	3.3	4.1	5.8	6.2	6.3
In percent of ARA composite metric	24.7	16.3	33.2	37.8	44.7	47.9	58.6	73.1	100.2	108.7	108.5
Usable Gross official reserves (end of period) 3/											
In millions of U.S. dollars	1,565	462	2,371	2,951	3,910	4,169	7,174	9,262	13,466	15,105	15,286
In months of prospective imports of goods & services	1.0	0.3	1.3	1.6	1.9	2.0	3.3	4.1	5.8	6.2	6.3
In percent of ARA composite metric	12.3	4.0	20.7	25.4	32.7	35.6	58.6	73.1	100.2	108.7	108.5
External debt (public and private)											
In billions of U.S. dollars	58.4	57.4	53.8	52.7	55.5	53.6	55.6	58.0	62.3	64.0	65.8
As a percent of GDP	65.9	77.0	64.7	62.5	68.0	61.1	64.4	65.7	68.5	67.2	65.0
Memorandum items:											
Nominal GDP (in billions of rupees)	17,612	24,064	28,033	27,630	31,422	30,917	33,958	36,839	39,959	43,287	46,869
Exchange Rate (period average)	198.8	322.6	...	327.5	...	...	...	...	...	...	...
Exchange Rate (end of period)	200.4	363.1	...	323.9	...	...	...	...	...	...	...

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). The debt statistics currently assume the external debt restructuring to have been completed at end 2023.

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

Table 2a. Sri Lanka: Summary of Central Government Operations, 2021-29 (Restructuring Scenario)

(In billions of Rupees)

	2021	2022	2023		2024			2025	2026	2027	2028	2029
	Act.		First Review	Prel.	Budget	First Review	Proj.	Proj.				
Total revenue and grants	1,464	2,013	2,847	3,074	4,127	4,081	4,194	5,117	5,634	6,147	6,661	7,200
Total revenue	1,457	1,979	2,835	3,049	4,107	4,067	4,165	5,086	5,600	6,110	6,621	7,157
Tax revenue	1,298	1,751	2,593	2,721	3,820	3,789	3,837	4,725	5,219	5,694	6,188	6,700
Income taxes	302	534	861	911	1,080	1,021	1,023	1,221	1,425	1,590	1,728	1,877
VAT	308	463	679	694	1,400	1,370	1,354	1,704	1,857	2,018	2,191	2,368
Excise taxes	307	343	450	470	545	545	550	688	740	807	881	960
Other taxes on goods and services	31	70	245	256	290	318	333	366	389	413	449	488
Taxes on international trade	350	341	357	389	505	536	577	746	808	867	939	1,006
Nontax revenue	159	228	243	328	287	278	328	361	381	416	433	456
Grants	7	33	12	26	20	13	29	31	34	37	40	43
Total expenditure and net lending 1/	3,522	4,473	5,317	5,357	6,978	7,020	6,855	6,898	7,328	7,781	8,318	8,993
Current expenditure	2,748	3,520	4,517	4,700	5,277	5,063	5,208	5,409	5,654	5,952	6,342	6,861
Wages and salaries	846	956	975	939	1,098	1,095	1,127	1,273	1,381	1,498	1,623	1,758
Goods and services	169	183	254	300	330	317	340	340	368	400	433	469
Subsidies and transfers	685	815	1,014	1,005	1,198	1,104	1,154	1,234	1,363	1,485	1,616	1,746
of which: social safety net transfers	…	142	187	187	205	205	205	221	240	260	282	305
Interest payments 2/	1,048	1,565	2,274	2,456	2,651	2,546	2,587	2,562	2,542	2,569	2,670	2,890
Capital expenditure and net lending 1/	774	953	800	657	1,701	1,957	1,646	1,489	1,674	1,829	1,975	2,132
Capital expenditure	768	715	800	914	1,260	1,312	1,251	1,489	1,674	1,829	1,975	2,132
Capital transfers 1/ 3/					450	644	395					
Net lending	7	237	0	-257	-9	0	0	0	0	0	0	0
Overall balance 1/	-2,058	-2,460	-2,470	-2,282	-2,851	-2,939	-2,661	-1,781	-1,694	-1,634	-1,657	-1,793
Financing	2,058	2,460	2,470	2,282	2,851	2,939	2,661	1,781	1,694	1,634	1,657	1,793
Privatization	0	0	0	0	0	0	0	0	0	0	0	0
Net external financing	-14	425	610	495	726	603	484	560	584	1,156	528	481
Net domestic financing	2,072	2,035	1,861	1,788	2,125	2,337	2,176	1,221	1,111	478	1,129	1,312
Memorandum items:												
Central government primary balance (program definition) 4/	-1,010	-895	-196	173	250	251	323	781	847	935	1,013	1,097
Central government primary balance	-1,010	-895	-196	173	-200	-393	-73	781	847	935	1,013	1,097
Central government debt 1/	18,082	27,899	30,223	30,335		34,674	33,632	36,809	39,893	42,587	44,687	46,930
Nominal GDP (in billion of rupees)	17,612	24,064	28,033	27,630	31,500	31,422	30,917	33,958	36,839	39,959	43,287	46,869

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

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

2/ Based on illustrative restructuring terms.

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

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

Table 2b. Sri Lanka: Summary of Central Government Operations, 2021-29 (Restructuring Scenario)

(In percent of GDP)

	2021	2022	2023		2024			2025	2026	2027	2028	2029
	Act.		First Review	Prel.	Budget	First Review	Proj.					
Total revenue and grants	8.3	8.4	10.2	11.1	13.1	13.0	13.6	15.1	15.3	15.4	15.4	15.4
Total revenue	8.3	8.2	10.1	11.0	13.0	12.9	13.5	15.0	15.2	15.3	15.3	15.3
Tax revenue	7.4	7.3	9.2	9.8	12.1	12.1	12.4	13.9	14.2	14.2	14.3	14.3
Income taxes	1.7	2.2	3.1	3.3	3.4	3.2	3.3	3.6	3.9	4.0	4.0	4.0
VAT	1.7	1.9	2.4	2.5	4.4	4.4	4.4	5.0	5.0	5.0	5.1	5.1
Excise taxes	1.7	1.4	1.6	1.7	1.7	1.7	1.8	2.0	2.0	2.0	2.0	2.0
Other taxes on goods and services	0.2	0.3	0.9	0.9	0.9	1.0	1.1	1.1	1.1	1.0	1.0	1.0
Taxes on international trade	2.0	1.4	1.3	1.4	1.6	1.7	1.9	2.2	2.2	2.2	2.2	2.1
Nontax revenue	0.9	0.9	0.9	1.2	0.9	0.9	1.1	1.1	1.0	1.0	1.0	1.0
Grants	0.0	0.1	0.0	0.1	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure and net lending 1/	20.0	18.6	19.0	19.4	22.2	22.3	22.2	20.3	19.9	19.5	19.2	19.2
Current expenditure	15.6	14.6	16.1	17.0	16.8	16.1	16.8	15.9	15.3	14.9	14.7	14.6
Wages and salaries	4.8	4.0	3.5	3.4	3.5	3.5	3.6	3.7	3.8	3.7	3.8	3.8
Goods and services	1.0	0.8	0.9	1.1	1.0	1.0	1.1	1.0	1.0	1.0	1.0	1.0
Subsidies and transfers	3.9	3.4	3.6	3.6	3.8	3.5	3.7	3.6	3.7	3.7	3.7	3.7
of which: social safety net transfers	…	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Interest payments 2/	6.0	6.5	8.1	8.9	8.4	8.1	8.4	7.5	6.9	6.4	6.2	6.2
Capital expenditure and net lending 1/	4.4	4.0	2.9	2.4	5.4	6.2	5.3	4.4	4.5	4.6	4.6	4.5
Capital expenditure	4.4	3.0	2.9	3.3	4.0	4.2	4.0	4.4	4.5	4.6	4.6	4.5
Capital transfers 1/ 3/					1.4	2.1	1.3					
Net lending	0.0	1.0	0.0	-0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance 1/	-11.7	-10.2	-8.8	-8.3	-9.1	-9.4	-8.6	-5.2	-4.6	-4.1	-3.8	-3.8
Financing	11.7	10.2	8.8	8.3	9.1	9.4	8.6	5.2	4.6	4.1	3.8	3.8
Privatization	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net external financing	-0.1	1.8	2.2	1.8	2.3	1.9	1.6	1.6	1.6	2.9	1.2	1.0
Net domestic financing	11.8	8.5	6.6	6.5	6.7	7.4	7.0	3.6	3.0	1.2	2.6	2.8
Memorandum items:												
Central government primary balance (program definition) 4/	-5.7	-3.7	-0.7	0.6	0.8	0.8	1.0	2.3	2.3	2.3	2.3	2.3
Central government primary balance	-5.7	-3.7	-0.7	0.6	-0.6	-1.3	-0.2	2.3	2.3	2.3	2.3	2.3
Central government debt 1/	102.7	115.9	107.8	109.8		110.3	108.8	108.4	108.3	106.6	103.2	100.1
Nominal GDP (in billion of rupees)	17,612	24,064	28,033	27,630	31,500	31,422	30,917	33,958	36,839	39,959	43,287	46,869

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

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

2/ Based on illustrative restructuring terms.

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

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

Table 3. Sri Lanka: Monetary Accounts, 2021-29 1/ (Restructuring Scenario)

(In billions of Rupees, unless otherwise indicated, end of period)

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
			Act.					Proj.			
Central Bank of Sri Lanka											
Net foreign assets	896	527	-387	-1,606	-837	-299	493	1,480	3,225	3,823	3,796
Net domestic assets	37	438	1,693	2,956	2,166	1,877	1,258	421	-1,164	-1,591	-1,378
Net claims on central government	363	869	2,094	3,432	2,376	2,110	1,590	1,070	600	280	160
o.w. Holdings of government securities for monetary operations 2/	52	-8	529	698	307	307	287	267	247	227	207
Other items, net	-328	-546	-544	-465	-229	-251	-350	-668	-1,783	-1,889	-1,557
Reserve Money	933	964	1,306	1,349	1,329	1,579	1,752	1,900	2,061	2,233	2,418
Currency in circulation	678	835	1,005	1,027	1,187	1,390	1,509	1,603	1,710	1,877	2,057
Commercial banks' deposits	255	130	301	323	142	189	243	297	351	356	360
Monetary survey											
Net foreign assets	101	-209	-982	-1,753	-456	283	865	1,599	3,089	3,685	3,655
Monetary authorities	896	527	-387	-1,606	-837	-299	493	1,480	3,225	3,823	3,796
Deposit money banks	-795	-736	-595	-146	381	582	372	119	-136	-139	-141
Net domestic assets	7,523	9,615	11,629	14,049	13,645	14,873	15,863	16,549	16,595	17,639	19,433
Net claims on central government	2,796	4,548	5,832	7,466	8,285	9,080	8,992	8,650	8,195	7,693	7,970
Credit to corporations	6,615	7,173	8,170	9,161	8,136	8,867	9,597	10,401	11,296	12,264	13,317
Public corporations	818	1,002	1,188	1,735	770	973	975	975	975	975	975
Private corporations	5,797	6,171	6,981	7,427	7,366	7,895	8,622	9,427	10,321	11,289	12,342
Other items (net)	-1,887	-2,106	-2,373	-2,579	-2,776	-3,075	-2,726	-2,503	-2,896	-2,318	-1,853
Broad money	7,624	9,406	10,647	12,296	13,189	15,155	16,728	18,147	19,684	21,323	23,088
Memorandum Items											
Gross international reserves (in millions of U.S. dollars)	7,642	5,664	3,139	1,898	4,387	5,605	7,174	9,262	13,466	15,105	15,286
Net international reserves (in millions of U.S. dollars)	5,871	3,543	-423	-3,196	-1,085	716	2,716	4,951	9,001	10,857	11,334
Net Foreign Assets of commercial banks (in millions of U.S. dollars)	-4,379	-3,950	-2,967	-403	1,177	1,527	917	278	-303	-303	-303
Reserve money (in percent of GDP)	5.9	6.2	7.4	5.6	4.8	5.1	5.2	5.2	5.2	5.2	5.2
Private credit (in percent of GDP)	36.4	39.4	39.6	30.9	26.7	25.5	25.4	25.6	25.8	26.1	26.3
Money multiplier	8.2	9.8	8.2	9.1	9.9	9.6	9.6	9.5	9.6	9.5	9.6
Broad money velocity	2.1	1.7	1.7	2.0	2.1	2.0	2.0	2.0	2.0	2.0	2.0
					(Annual percentage change)						
Nominal GDP	3.6	-1.7	12.6	36.6	14.8	11.9	9.8	8.5	8.5	8.3	8.3
Broad money	7.0	23.4	13.2	15.5	7.3	14.9	10.4	8.5	8.5	8.3	8.3
Reserve money	-3.0	3.4	35.4	3.3	-1.5	18.8	11.0	8.5	8.5	8.3	8.3
Credit to private sector	4.2	6.5	13.1	6.4	-0.8	7.2	9.2	9.3	9.5	9.4	9.3
Credit to private sector (adjusted for inflation)	-0.1	1.9	7.2	-38.8	-18.2	0.2	3.4	4.0	4.3	4.3	4.3

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

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

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

Table 4a. Sri Lanka: Balance of Payments, 2021–29 (Restructuring Scenario)
(In millions of U.S. dollars, unless otherwise indicated)

	2021	2022	2023	2023	2024	2024	2025	2026	2027	2028	2029
	Act.		First Review	Proj.	First Review	Proj.	Proj.				
Current account	**-3,285**	**-744**	**1,232**	**2,644**	**-634**	**412**	**-926**	**-1,031**	**-804**	**-819**	**-840**
Balance on goods	-8,139	-5,185	-5,523	-4,900	-7,163	-7,146	-8,942	-9,444	-9,459	-9,665	-9,979
Credit (exports)	12,499	13,106	12,365	11,911	13,555	12,913	13,624	14,261	14,903	15,591	16,384
Debit (imports)	-20,638	-18,291	-17,887	-16,811	-20,718	-20,059	-22,565	-23,706	-24,362	-25,255	-26,363
Non-oil imports	-16,895	-13,394	-13,341	-12,108	-16,025	-14,987	-17,596	-18,792	-19,409	-20,229	-21,219
Oil imports	-3,743	-4,897	-4,546	-4,703	-4,693	-5,072	-4,969	-4,914	-4,953	-5,027	-5,143
Balance on services	1,586	2,110	2,868	3,403	2,821	4,031	4,273	4,412	4,644	4,852	5,056
Credit (exports)	2,475	3,062	4,438	5,410	4,620	6,324	6,718	6,965	7,312	7,642	7,988
Debit (imports)	-889	-953	-1,570	-2,007	-1,798	-2,294	-2,444	-2,553	-2,668	-2,790	-2,933
Primary income, net	-1,960	-1,165	-1,715	-1,438	-2,119	-2,241	-2,129	-2,114	-2,244	-2,389	-2,398
Secondary income, net	5,227	3,496	5,602	5,580	5,827	5,768	5,871	6,115	6,255	6,383	6,481
General government (net)	6	3	0	0	0	0	-1	-1	-1	0	1
Of which: workers' remittances (net)	5,221	3,493	5,602	5,580	5,826	5,768	5,872	6,116	6,255	6,382	6,480
Capital account (+ surplus / - deficit)	**25**	**19**	**12**	**36**	**12**	**12**	**12**	**12**	**12**	**12**	**12**
Balance from current account and capital account	**-3,260**	**-725**	**1,244**	**2,680**	**-622**	**424**	**-914**	**-1,019**	**-792**	**-807**	**-828**
Financial account (+ net lending / - net borrowing) 1/	**-1,750**	**-141**	**-156**	**696**	**-1,693**	**-327**	**-2,015**	**-2,624**	**-4,842**	**-2,663**	**-1,306**
Direct investments	-574	-883	-775	-600	-1,200	-800	-1,120	-1,400	-1,500	-1,530	-1,560
Portfolio investments	1,547	201	-256	-271	-260	90	-13	-20	-1,520	-652	923
Equity and investment Fund shares	232	-137	-30	-30	-100	0	0	0	0	0	0
Debt instruments	1,314	338	-226	-241	-160	90	-13	-20	-1,520	-652	923
Of which: deposit taking corporations	0	0	0	0	0	0	0	0	0	0	0
Of which: general government	1,314	338	-226	-241	-160	90	-13	-20	-1,520	-652	923
T-bills, T-bonds, and SLDBs	28	-53	-226	-241	-160	90	-13	-20	-20	-20	-20
Sovereign bonds	1,286	391	0	0	0	0	0	0	-1,500	-632	943
Other investments 2/	-2,723	541	875	1,567	-233	383	-882	-1,204	-1,822	-480	-668
Of which:											
Currency and deposits	-3,709	245	-825	-1,024	1,072	1,250	680	380	-250	0	0
Central bank	-1,375	-400	-1,675	-1,750	900	900	900	630	0	0	0
Deposit taking corporations	-2,334	645	851	726	172	350	-220	-250	-250	0	0
Loans 2/	1,447	103	-641	251	-1,283	-607	-1,673	-1,503	-1,475	-543	-731
Deposit taking corporations	2,153	1,645	269	561	-137	0	-390	-389	-331	-8	-8
General government	-874	-1,545	-1,140	-1,140	-1,097	-907	-1,143	-964	-994	-535	-723
Disbursements	-2,100	-2,316	-2,150	-2,150	-1,980	-1,768	-2,433	-2,298	-2,201	-1,701	-1,752
Amortizations	1,815	1,153	1,010	1,010	883	861	1,290	1,334	1,207	1,166	1,029
Other sectors	168	3	230	830	-49	300	-140	-150	-150	0	0
SDR allocation	-787	0	0	0	0	0	0	0	0	0	1
Other accounts receivable/payable (incl. ACU balance)	-180	-1,491	1,994	1,994	0	0	0	0	0	0	0
Errors and omissions	-1,739	-512	0	0	0	0	0	0	0	0	0
Overall balance (- = need of inflow) 1/	**-3,249**	**-1,095**	**1,400**	**1,984**	**1,071**	**751**	**1,101**	**1,605**	**4,050**	**1,856**	**478**
Financing (- = inflow)	**-3,249**	**-1,095**	**2,082**	**2,661**	**1,752**	**1,430**	**1,781**	**2,286**	**4,389**	**1,851**	**472**
Change in reserve assets	-3,306	-1,235	1,909	2,489	1,539	1,218	1,569	2,088	4,203	1,639	180
Use of Fund credit, net	57	140	173	172	213	212	212	198	185	212	292
Financing gap (- = inflow) 4/	**0**	**0**	**-682**	**-678**	**-682**	**-679**	**-682**	**-683**	**-342**	**0**	**0**
IMF	0	0	-682	-678	-682	-679	-682	-683	-342	0	0
Other IFIs	0	0	0	0	0	0	0	0	0	0	0
Memorandum items:											
Current account (in percent of GDP)	-3.7	-1.0	1.5	3.1	-0.8	0.5	-1.1	-1.2	-0.9	-0.9	-0.8
Gross official reserves	3,139	1,898	3,806	4,387	5,346	5,605	7,174	9,262	13,466	15,105	15,286
In months of prospective imports of goods and services	2.0	1.2	2.0	2.4	2.6	2.7	3.3	4.1	5.8	6.2	6.3
In percent of ARA composite metric	24.7	16.3	33.2	37.8	44.7	47.9	58.6	73.1	100.2	108.7	108.5
Usable Gross official reserves 3/	1,565	462	2,371	2,951	3,910	4,169	7,174	9,262	13,466	15,105	15,286
In months of prospective imports of goods and services	1.0	0.3	1.3	1.6	1.9	2.0	3.3	4.1	5.8	6.2	6.3
In percent of ARA composite metric	12.3	4.0	20.7	25.4	32.7	35.6	58.6	73.1	100.2	108.7	108.5
Net international reserves	-423	-3,196	-1,317	-1,085	638	716	2,716	4,951	9,001	10,857	11,334
In percent of ARA composite metric	-3.3	…	…	…	5.3	6.1	22.2	39.1	67.0	78.1	80.5

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

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

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

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

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

Table 4b. Sri Lanka: Balance of Payments, 2021-29 (Restructuring Scenario)

(In percent of GDP, unless otherwise indicated)

	2021	2022	2023	2023	2024	2024	2025	2026	2027	2028	2029
	Act.		First Review	Proj.	First Review	Proj.			Proj.		
Current account	**-3.7**	**-1.0**	**1.5**	**3.1**	**-0.8**	**0.5**	**-1.1**	**-1.2**	**-0.9**	**-0.9**	**-0.8**
Balance on goods	-9.2	-7.0	-6.6	-5.8	-8.8	-8.1	-10.4	-10.7	-10.4	-10.1	-9.8
Credit (exports)	14.1	17.6	14.9	14.1	16.6	14.7	15.8	16.1	16.4	16.4	16.2
Debit (imports)	-23.3	-24.5	-21.5	-19.9	-25.4	-22.9	-26.1	-26.8	-26.8	-26.5	-26.0
Non-oil imports	-19.1	-18.0	-16.0	-14.4	-19.6	-17.1	-20.4	-21.3	-21.3	-21.2	-20.9
Oil imports	-4.2	-6.6	-5.5	-5.6	-5.7	-5.8	-5.8	-5.6	-5.4	-5.3	-5.1
Balance on services	1.8	2.8	3.4	4.0	3.5	4.6	4.9	5.0	5.1	5.1	5.0
Credit (exports)	2.8	4.1	5.3	6.4	5.7	7.2	7.8	7.9	8.0	8.0	7.9
Debit (imports)	-1.0	-1.3	-1.9	-2.4	-2.2	-2.6	-2.8	-2.9	-2.9	-2.9	-2.9
Primary income, net	-2.2	-1.6	-2.1	-1.7	-2.6	-2.6	-2.5	-2.4	-2.5	-2.5	-2.4
Secondary income, net	5.9	4.7	6.7	6.6	7.1	6.6	6.8	6.9	6.9	6.7	6.4
Of which: workers' remittances (net)	5.9	4.7	6.7	6.6	7.1	6.6	6.8	6.9	6.9	6.7	6.4
Capital account (+ surplus / - deficit)	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Balance from current account and capital account	**-3.7**	**-1.0**	**1.5**	**3.2**	**-0.8**	**0.5**	**-1.1**	**-1.2**	**-0.9**	**-0.8**	**-0.8**
Financial account (+ net lending / - net borrowing) 1/	**-2.0**	**-0.2**	**-0.2**	**0.8**	**-2.1**	**-0.4**	**-2.3**	**-3.0**	**-5.3**	**-2.8**	**-1.3**
Direct investments	-0.6	-1.2	-0.9	-0.7	-1.5	-0.9	-1.3	-1.6	-1.6	-1.6	-1.5
Portfolio investments	1.7	0.3	-0.3	-0.3	-0.3	0.1	0.0	0.0	-1.7	-0.7	0.9
Equity and investment Fund shares	0.3	-0.2	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Debt instruments	1.5	0.5	-0.3	-0.3	-0.2	0.1	0.0	0.0	-1.7	-0.7	0.9
Of which: deposit taking corporations	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Of which: general government	1.5	0.5	-0.3	-0.3	-0.2	0.1	0.0	0.0	-1.7	-0.7	0.9
T-bills, T-bonds, and SLDBs	0.0	-0.1	-0.3	-0.3	-0.2	0.1	0.0	0.0	0.0	0.0	0.0
Sovereign bonds	1.5	0.5	0.0	0.0	0.0	0.0	0.0	0.0	-1.6	-0.7	0.9
Other investments 2/	-3.1	0.7	1.1	1.9	-0.3	0.4	-1.0	-1.4	-2.0	-0.5	-0.7
Of which:	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Currency and deposits	-4.2	0.3	-1.0	-1.2	1.3	1.4	0.8	0.4	-0.3	0.0	0.0
Central bank	-1.6	-0.5	-2.0	-2.1	1.1	1.0	1.0	0.7	0.0	0.0	0.0
Deposit taking corporations	-2.6	0.9	1.0	0.9	0.2	0.4	-0.3	-0.3	-0.3	0.0	0.0
Loans 2/	1.6	0.1	-0.8	0.3	-1.6	-0.7	-1.9	-1.7	-1.6	-0.6	-0.7
Deposit taking corporations	2.4	2.2	0.3	0.7	-0.2	0.0	-0.5	-0.4	-0.4	0.0	0.0
General government	-1.0	-2.1	-1.4	-1.4	-1.3	-1.0	-1.3	-1.1	-1.1	-0.6	-0.7
Disbursements	-2.4	-3.1	-2.6	-2.5	-2.4	-2.0	-2.8	-2.6	-2.4	-1.8	-1.7
Amortizations	2.0	1.5	1.2	1.2	1.1	1.0	1.5	1.5	1.3	1.2	1.0
Other sectors	0.2	0.0	0.3	1.0	-0.1	0.3	-0.2	-0.2	-0.2	0.0	0.0
SDR allocation	-0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable/payable (incl. ACU balance)	-0.2	-2.0	2.4	2.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-2.0	-0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance (- = need of inflow) 1/	**-3.7**	**-1.5**	**1.7**	**2.4**	**1.3**	**0.9**	**1.3**	**1.8**	**4.5**	**1.9**	**0.5**
Financing (- = inflow)	**-3.7**	**-1.5**	**2.5**	**3.2**	**2.1**	**1.6**	**2.1**	**2.6**	**4.8**	**1.9**	**0.5**
Change in reserve assets	-3.7	-1.7	2.3	3.0	1.9	1.4	1.8	2.4	4.6	1.7	0.2
Use of Fund credit, net	0.1	0.2	0.2	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.3
Financing gap (- = inflow) 4/	**0.0**	**0.0**	**-0.8**	**-0.8**	**-0.8**	**-0.8**	**-0.8**	**-0.8**	**-0.4**	**0.0**	**0.0**
IMF	**0.0**	**0.0**	**-0.8**	**-0.8**	**-0.8**	**-0.8**	**-0.8**	**-0.8**	**-0.4**	**0.0**	**0.0**
Other IFIs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Current account (in percent of GDP)	-3.7	-1.0	1.5	3.1	-0.8	0.5	-1.1	-1.2	-0.9	-0.9	-0.8
Gross official reserves	3,139	1,898	3,806	4,387	5,346	5,605	7,174	9,262	13,466	15,105	15,286
In months of prospective imports of goods and services	2.0	1.2	2.0	2.4	2.6	2.7	3.3	4.1	5.8	6.2	6.3
In percent of ARA composite metric	24.7	16.3	33.2	37.8	44.7	47.9	58.6	73.1	100.2	108.7	108.5
Usable Gross official reserves 3/	1,565	462	2,371	2,951	3,910	4,169	7,174	9,262	13,466	15,105	15,286
In months of prospective imports of goods and services	1.0	0.3	1.3	1.6	1.9	2.0	3.3	4.1	5.8	6.2	6.3
In percent of ARA composite metric	12.3	4.0	20.7	25.4	32.7	35.6	58.6	73.1	100.2	108.7	108.5
Net international reserves	-423	-3,196	-1,317	-1,085	638	716	2,716	4,951	9,001	10,857	11,334
In percent of ARA composite metric	-3.3	...	...	...	5.3	6.1	22.2	39.1	67.0	78.1	80.5

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

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

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

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

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

Table 5. Sri Lanka: Decomposition of Public Debt and Debt Service by Creditor, 2023-26 1/

	Debt Stock (end of period, incl. arrears and past due interest) 2023			Debt Service on end-2023 debt stock (on contractual terms)					
				2024	2025	2026	2024	2025	2026
	(In US$mn)	*(Percent total debt)*	*(Percent GDP)*	*(In US$mn)*			*(Percent GDP)*		
Total public debt	**98,660**	**100.0**	**115.7**	**24,082**	**11,870**	**9,404**	**28.5**	**13.3**	**10.8**
External (foreign law)	**43,323**	**43.9**	**50.8**	**5,491**	**6,144**	**4,461**	**6.5**	**6.9**	**5.1**
Multilateral creditors[2]	13,175	13.4	15.4	1,288	1,305	1,348	1.5	1.5	1.6
IMF	1,579	1.6	1.9	274	268	245	0.3	0.3	0.3
World Bank	4,388	4.4	5.1	307	325	328	0.4	0.4	0.4
ADB	6,583	6.7	7.7	598	603	669	0.7	0.7	0.8
Other Multilaterals	625	0.6	0.7	110	108	106	0.1	0.1	0.1
Bilateral Creditors	11,100	11.3	13.0	1,021	1,305	935	1.2	1.5	1.1
Paris Club	4,834	4.9	5.7	293	278	263	0.3	0.3	0.3
o/w: Japan	2,676	2.7	3.1	179	170	167	0.2	0.2	0.2
Non-Paris Club	6,266	6.4	7.3	728	1,027	672	0.9	1.1	0.8
o/w: China	4,349	4.4	5.1	546	477	423	0.6	0.5	0.5
India	1,575	1.6	1.8	110	499	232	0.1	0.6	0.3
Bonds	14,130	14.3	16.6	2,336	2,741	1,469	2.8	3.1	1.7
Commercial creditors	3,498	3.5	4.1	845	793	709	1.0	0.9	0.8
o/w: China Development Bank	3,241	3.3	3.8	651	620	559	0.8	0.7	0.6
Central bank bilateral currency swaps	1,420	1.4	1.7	-	-	-	0.0	-	-
Domestic (local law)	**55,338**	**56.1**	**64.9**	**18,592**	**5,726**	**4,944**	**22.0**	**6.4**	**5.7**
T-Bills	12,634	12.8	14.8	11,614	-	-	13.8	-	-
Bonds	37,423	37.9	43.9	6,780	5,509	4,799	8.0	6.2	5.5
Others	5,281	5.4	6.2	197	216	144	0.2	0.2	0.2
Memo items:									
Collateralized debt[3]	0	0	0						
o/w: Related	0	0	0						
o/w: Unrelated	0	0	0						
Contingent liabilities									
o/w: Public guarantees	(included in public debt)								
o/w: Other explicit contingent liabilities									
Exchange rate (eop., Rupees/$)	324								
Nominal GDP (billions of Rupees)	27,630								

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

2/Multilateral creditors" are simply institutions with more than one official shareholder and may not necessarily align with creditor classification under other IMF policies

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

Table 6. Sri Lanka: Gross External Financing, 2021-29 (Restructuring Scenario)

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

	2021	2022	2023	2024	2025	2026	2027	2028	2029
			Proj.						
Current account	-3,285	-744	2,644	412	-926	-1,031	-804	-819	-840
Balance on goods	-8,139	-5,185	-4,900	-7,146	-8,942	-9,444	-9,459	-9,665	-9,979
Credit (exports)	12,499	13,106	11,911	12,913	13,624	14,261	14,903	15,591	16,384
Debit (imports)	-20,638	-18,291	-16,811	-20,059	-22,565	-23,706	-24,362	-25,255	-26,363
Balance on services	1,586	2,110	3,403	4,031	4,273	4,412	4,644	4,852	5,056
Credit (exports)	2,475	3,062	5,410	6,324	6,718	6,965	7,312	7,642	7,988
Debit (imports)	-889	-953	-2,007	-2,294	-2,444	-2,553	-2,668	-2,790	-2,933
Primary and secondary income, net	3,267	2,331	4,142	3,527	3,742	4,001	4,010	3,994	4,084
Amortization	-1851	-1727	-262	-2273	-3283	-3044	-2276	-3205	-3148
General government	-2,815	-1,653	-1,010	-861	-1,290	-1,334	-1,207	-2,108	-1,971
Sovereign bonds	-1000	-500	0	0	0	0	0	-943	-943
Syndicated loans	-92	0	0	0	0	0	0	0	0
Bilateral and multilateral	-1,723	-1,153	-1,010	-861	-1,290	-1,334	-1,207	-1,166	-1,029
Central bank	1318	260	1578	-1112	-1113	-830	-188	-216	-297
IMF repurchases/repayments	-57	-140	-172	-212	-213	-200	-188	-216	-297
Other central bank liabilities, net	1375	400	1750	-900	-900	-630	0	0	0
Private sector loans	-354	-335	-830	-300	-880	-880	-880	-880	-880
Debt service on treated CG and guaranteed debt on pre-restructuring terms	...	-2,834	-3,772	-4,061	-4,366	-2,941	-2,974	-2,513	-2,493
Principal	...	-2,107	-2,628	-3,088	-3,524	-2,274	-2,463	-2,126	-2,232
Interest	...	-727	-1,144	-973	-842	-667	-511	-387	-261
Debt service on treated CG and guaranteed debt debt post-restructuring	...	0	0	887	987	976	965	1,718	1,935
Principal	...	0	0	324	413	413	413	1,150	1,242
Interest	...	0	0	563	574	563	552	568	693
Gross external financing needs	-5,136	-5,305	-1,390	-5,035	-7,588	-6,040	-5,088	-4,819	-4,547
Sources of financing	5,136	5,305	1,390	5,035	7,588	6,040	5,088	4,819	4,547
Borrowing	1830	1,748	-1,790	1,632	4,357	4,922	6392	5663	4727
General government	2083	2,376	1,171	910	1,706	1,760	3171	3296	1772
T-bills, Tbonds, and SLDBs, net	-28	53	241	-90	13	20	20	20	20
Sovereign bonds	0	0	0	0	0	0	1500	1575	0
Syndicated loans	800	0	0	0	0	0	0	0	0
Bilateral and multilateral	1300	2,316	930	1,000	1,693	1,740	1651	1701	1752
Official capital transfers	11	7	0	0	0	0	0	0	0
Other capital inflows, net	-253	-628	-2,961	722	2,651	3,162	3,221	2,368	2,956
Deposit-taking corporations, excl. central bank, net	361	-2,769	-1,287	-362	587	624	567	-7	-7
FDI inflows, net	574	883	600	800	1,120	1,400	1,500	1,530	1,560
Private sector loans	186	332	0	0	1,020	1,030	1,000	880	880
Other capital inflows, net	-1374	926	-2,274	284	-76	108	154	-36	522
Change in reserve assets	3,306	723	-2,489	-1,218	-1,569	-2,088	-4,203	-1,639	-180
External financing gap	0	2,834	5,670	4,621	4,800	3,206	2,900	795	0
Exceptional Financing	...	2,834	5,670	4,621	4,800	3,206	2,900	795	0
IMF EFF	...	0	678	679	682	683	342	0	0
IFI budget support	...	0	1,220	768	740	558	550	0	0
Debt moratorium: external arrears accumulation	...	2,834	3,772	0	0	0	0	0	0
Debt relief	...	0	0	3,174	3,378	1,965	2,008	795	0

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

Table 7. Sri Lanka: Financial Soundness Indicators – All Banks, 2021-23

	2021				2022				2023			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Capital adequacy												
Regulatory capital to risk weighted assets	16.6	16.3	16.2	16.5	15.1	15.2	15.3	16.1	16.5	16.9	16.4	16.9
Tier 1 capital/risk weighted assets	13.3	13.0	12.9	13.2	12.1	12.2	12.4	13.1	13.5	13.9	13.5	13.8
Equity capital and reserves to assets ratio	8.5	8.5	8.5	8.7	7.8	7.6	7.8	8.2	8.5	8.6	8.7	8.7
Asset quality												
Gross nonperforming loans to total gross loans (without interest in suspense)	4.6	5.0	4.8	4.5	8.4	8.9	10.8	11.6	12.9	13.4	13.4	12.7
Net nonperforming loans to total gross loans	2.1	2.4	2.2	1.7	8.4	9.4	10.8	11.3	12.7	13.4	13.6	12.8
Provision coverage ratio (total)	65.2	62.3	66.8	75.8	45.1	46.5	43.6	45.2	45.8	44.9	46.9	49.0
Earnings and profitability												
Return on equity (after tax)	16.4	16.5	15.1	14.5	20.4	8.8	8.0	10.4	10.2	10.2	11.1	10.6
Return on assets (after tax)	1.4	1.4	1.3	1.2	1.6	0.7	0.6	0.8	0.8	0.8	1.0	0.9
Net Interest income to gross income	70.9	74.1	75.9	76.7	4.2	4.3	4.1	4.0	3.7	3.5	3.5	3.6
Staff expenses to noninterest expenses	46.7	46.6	45.4	45.2	53.9	53.3	53.7	53.5	50.9	50.7	51.3	50.9
Total cost to total income	69.2	69.4	70.1	69.5	53.7	59.7	66.0	70.0	81.5	83.1	81.6	80.6
Net interest margin	3.5	3.5	3.4	3.4	4.2	4.3	4.1	4.0	3.7	3.5	3.5	3.6
Liquidity												
Liquid assets to total assets	34.0	33.3	30.2	29.7	27.4	25.7	25.3	27.4	30.6	33.1	38.9	39.8
Assets/funding structure												
Deposits to total assets	76.0	76.1	75.6	76.4	75.9	75.6	77.4	78.8	80.5	80.4	81.0	81.5
Borrowings to total assets	11.6	11.6	12.3	13.1	13.0	13.1	11.2	9.6	7.8	7.8	6.9	6.8

Source: CBSL.

Table 8. Sri Lanka: Projected Payments to the Fund, 2023-36 1/

(In millions of SDRs, unless otherwise indicated)

	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036
Fund repurchases and charges														
In millions of SDR	208.2	266.0	294.7	309.5	325.3	347.6	397.7	433.5	493.5	484.7	440.0	338.2	240.6	147.8
In millions of U.S. dollars	277.7	355.7	395.5	416.3	438.2	468.3	535.7	583.9	664.7	653.0	592.8	455.6	324.1	199.1
In percent of exports of goods and services	1.6	1.8	1.9	2.0	2.0	2.0	2.2	2.3	2.5	2.4	2.0	1.5	1.0	0.6
In percent of government fiscal revenue	3.0	3.0	3.1	3.1	3.1	3.2	3.5	3.6	3.9	3.6	3.2	2.3	1.6	0.9
In percent of quota	36.0	46.0	50.9	53.5	56.2	60.1	68.7	74.9	85.3	83.7	76.0	58.4	41.6	25.5
In percent of gross official reserves	6.3	6.3	5.5	4.5	3.3	3.1	3.5	3.7	4.1	3.9	3.4	2.6	1.8	1.1
Fund credit outstanding 2/														
In millions of SDR	1,176.8	1,526.1	1,875.4	2,234.7	2,348.8	2,188.6	1,968.5	1,693.3	1,333.5	952.5	592.7	317.5	127.0	21.2
In millions of U.S. dollars	1,570	2,044	2,520	3,007	3,169	2,953	2,656.0	2,284.7	1,799.2	1,285.2	799.7	428.4	171.4	28.6
In percent of exports of goods and services	9.1	10.6	12.4	14.2	14.3	12.7	10.9	9.0	6.8	4.6	2.8	1.4	0.5	0.1
In percent of government fiscal revenue	16.9	17.3	19.5	22.4	22.8	20.2	17.3	14.1	10.6	7.2	4.2	2.2	0.8	0.1
In percent of quota	203.3	263.7	324.0	386.1	405.8	378.1	340.1	292.6	230.4	164.6	102.4	54.9	21.9	3.7
In percent of GDP	1.9	2.3	2.9	3.4	3.5	3.1	2.6	2.2	1.6	1.1	0.6	0.3	0.1	0.0
In percent of gross official reserves	35.8	36.5	35.1	32.5	23.5	19.5	17.4	14.5	11.0	7.7	4.6	2.4	0.9	0.2
Memorandum items:														
Exports of goods and services (in millions of U.S. dollars)	17,321	19,237	20,341	21,227	22,216	23,233	24,279	25,371	26,513	27,706	28,953	30,256	31,617	33,040
Central government fiscal revenue (billion of Rupees)	3,049	4,165	5,086	5,600	6,114	6,648	7,228	7,859	8,544	9,290	10,100	10,982	11,940	12,982
Quota 2/	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8	578.8
Quota (in millions of U.S. dollars) 2/	772	775	778	779	781	781	781	781	781	781	781	781	781	781
Gross official reserves (in millions of U.S. dollars) 2/	4,387	5,605	7,174	9,262	13,466	15,105	15,286	15,786	16,286	16,786	17,286	17,786	18,286	18,786

Source: IMF staff estimates.
1/ Projections as of Apr 25, 2024.
2/ As of the end of the year.

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

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

Source: IMF staff.

Annex I. Implementation of the Key Recommendations of the 2021 Article IV Consultation

Recommendations	Status
Fiscal Policy	
Revenue-based fiscal consolidation through high-quality and permanent revenue measures.	The authorities adopted a package of tax reforms since September 2022 comprising of: (i) increasing PIT and CIT marginal tax rates and lowering the liable thresholds, (ii) reintroducing mandatory income tax withholding, (iii) increasing the VAT tax rates and reducing registration threshold and (iv) removing many VAT tax exemptions. Work is underway with FAD TA assistance to introduce an imputed rental income tax in lieu of the property tax.
Strengthen revenue administration.	The authorities are focusing efforts to improve compliance from large taxpayers through reforms to the Large Taxpayers Unit (LTU) of IRD. Work is underway to adopt performance indicators for IRD to improve on-time payments, tax filings, reporting and registration. The authorities have adopted a strategy to repeal the SVAT in April 2025.
Adopt cost-recovery energy pricing	The authorities introduced automatic formula-based adjustments for setting fuel prices on a monthly basis and on a quarterly basis for electricity prices. Both CPC and CEB made small profits in 2023.
Improve budget formulation and execution.	A draft PFM bill focusing on enhancing the fiscal rules framework through better compliance and accountability mechanisms as well as improved transparency was submitted to Parliament in May 2024.
Implement social safety net (SSN) reforms to protect the poor and the vulnerable	Major SSN reforms were introduced to improve targeting, coverage, and adequacy including establishing a welfare benefit payment scheme and the application of the new eligibility criteria to better identify low-income families for receiving welfare benefit payments. The full transition to the new scheme is delayed due to a large number of grievances, which the authorities are trying to resolve by March 2024.
Monetary and Financial Sector Policies	
A tighter monetary policy to bring inflation closer the CBSL target.	Policy rate hikes in 2022 helped the CBSL reduce inflation from 70 percent to low single digits.
Phase out monetary financing.	Net Credit to Government has declined in 2023 and further offloading of government securities is expected in 2024 until September under the EFF. The revised CBA, enacted in September 2023 prohibits further monetary financing except for extraordinary circumstances.
Strengthen the institutional and legal framework of debt management by passing the Public Debt Management Law and setup of Public Debt Management Office	The public debt management law was submitted for Parliamentary approval on April 26, 2024. . But the preparation work for the setup of public debt management office will be further delayed, the office is expected to be fully functional by the end of 2025.

Recommendations	Status
BoP policies	
Rebuild reserves and ensure a gradual return to a market-determined and flexible exchange rate.	The CBSL dropped the guidance to confine daily movements within a pre-defined band in March 2023. The CBSL has gradually rebuilt GIR through outright FX purchases under the EFF.
Relax import restrictions and remove temporary capital flow management measures (CFMs).	The authorities relaxed import restrictions apart from motor vehicles, with removal of remaining restrictions to be considered after the completion of the debt restructuring so as not to generate undue current account pressures. Some CFMs identified in the 2021 AIV SR were eliminated.
Develop a comprehensive strategy to restore debt sustainability.	The authorities have been engaged in various elements of the push towards retaining debt sustainability through a) macroeconomic adjustment including fiscal, exchange rate, monetary and structural policies, b) working to complete debt restructuring with their external creditors, and c) finalizing the treatment of the foreign exchange denominated portion of their domestic debt operation.
Governance	
Undertake efforts to strengthen governance and reduce corruption vulnerabilities.	The authorities enacted a new Anti-corruption bill and published an IMF-led Governance Diagnostic Report in 2023, and an action plan based on the recommendations in GD report in February 2024. CIABOC commissioners were appointed and rules for the selection process of commissioners were published by end-December 2023.

Annex II. Sovereign Risk and Debt Sustainability Analysis (SRDSA)

This SRDSA focuses on changes in assumptions relative to the first program review staff report and provides an assessment of the latest indicative debt treatment scenario for external debt, along with latest scenario for restructuring local law CPC FX debt.

DSA Assumptions

1. The macroeconomic framework has been updated to reflect recent developments since November 2023. This update includes (i) a small upside surprise to 2023 growth, ii) stronger primary balance in 2023 which was offset by a larger interest bill, and (ii) less than expected depreciation by end 2023. The debt-to-GDP outcomes in 2023 stood at 115.7, higher than projected at first review due to i) the assumption on the restructuring date changing to 2024, and ii) overfinancing by the government to build cash buffers . The medium-term projections of macro variables remain anchored at (i) Sri Lanka's medium-term growth potential, (ii) the central bank's inflation target, and (iii) the External Balance Assessment (EBA)-based misalignment and external adjustment needs, respectively. The REER adjustment, consistent with the results of the new external sector assessment, is similar to the first review. However, given the more appreciated starting position of the exchange rate, the medium-term nominal exchange rate levels are stronger than projected during the first review. These changes contribute to a slightly lower projected debt to GDP path.

Text Table 1. DSA Macroeconomic Assumptions – Differences with First Review

	2023	2024	2025	2026	2027	2028	2029
Real growth (%)							
1st Review	-3.6	1.8	2.7	3.0	3.1	3.1	3.1
Current	-2.3	2.0	2.7	3.0	3.1	3.1	3.1
GDP deflator inflation (yoy, %)							
1st Review	20.4	10.1	6.3	5.4	5.3	5.2	5.2
Current	17.5	9.8	6.9	5.4	5.2	5.1	5.0
Primary balance (% of GDP)							
1st Review	-0.7	0.8	2.3	2.3	2.3	2.3	2.3
Current	0.6	1.0	2.3	2.3	2.3	2.3	2.3
Nominal GDP (Rs bln)							
1st Review	28,033	31,422	34,291	37,226	40,397	43,812	47,515
Current	27,630	30,917	33,958	36,839	39,959	43,287	46,869

Source: IMF staff estimates and projections.

2. Financing assumptions are updated to reflect recent developments, including challenges in lengthening maturities of domestic issuances. While domestic interest rates declined since the execution of the Domestic Debt Operation (DDO), they remained high in 2023 relative to first review projections, leading to a greater than projected interest bill (8.9 percent of GDP). Since then, Q1 2024 has seen an improvement in the sovereign risk premium, with the T-bill rates coming down to 10 percent, but rates on longer term bonds remain high. The authorities have found it challenging to issue larger amounts of longer-term bonds amid uncertainties on the external debt restructuring and upcoming elections. This update incorporates these developments by raising the effective interest rate and increasing dependence on shorter term T-bonds in the total financing mix for 2024. This offsets the improvement in the GFN paths due to the positive changes in the macro assumptions. This DSA includes updated assumptions on the remaining SOE local law FX-denominated debt restructuring (CPC FX loans). Finally, the recapitalization contingency for banks and the central bank remains at 5 percent of 2022 GDP.

3. A key risk is the ability to access continued domestic financing at reasonable interest rates. Most gross domestic issuances in 2024 (mostly T-bills and shorter end T-bonds) are expected to be absorbed by banks and pension funds, within their respective absorptive capacity following the DDO. Starting 2025, the framework assumes that the authorities can issue more long-term T-bonds in line with historical patterns.[1] Downside risks to these assumptions stem from the amount of net financing the non-bank domestic financial sector can provide in the near term and their appetite for longer term bonds. If the non-bank sector's provision of financing lags, delaying the transition towards more long-term bonds, the banking system will have to absorb a larger share of domestic financing than assumed, and in the form of short-term debt, crowding out private credit and sapping economic growth. This may lead to a reversal in the reductions of the sovereign risk premium. The authorities are expected to employ part of their cash buffers in 2024-26 to limit borrowing and mitigate these risks.

4. Debt restructuring assumptions reflect indicative terms consistent with the recent AIPs with external official creditors and the authorities' indicative debt treatment scenario. These indicative terms feature principal haircut and step-up coupon in the proposed ISB treatment (in line with authorities' latest offer to bondholders), maturity extension with lower interest rate and progressive amortization profile in the proposed bilateral debt treatment. The proposed debt treatments for foreign creditors imply a meaningful Net Present Value (NPV) reduction to meet the program's debt targets and are still under negotiation on a confidential basis—so they cannot be further described in the DSA. Annex VII describes the progress on the debt restructuring front, recent developments and the remaining issues.

Compliance with Debt Targets

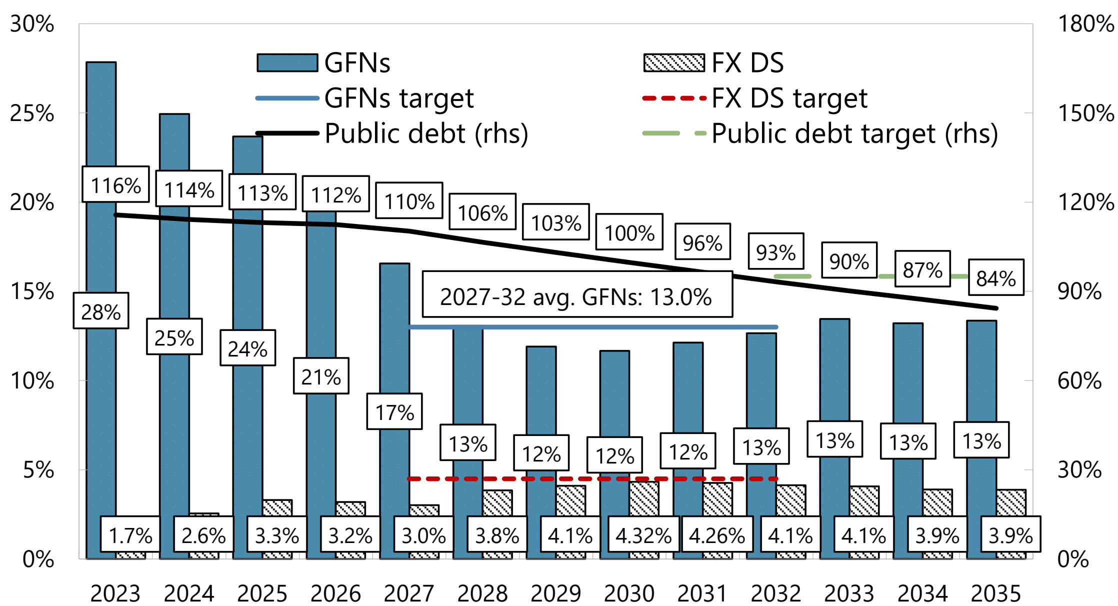
5. All four debt targets are respected in the authorities' abovementioned restructuring strategy (text chart), and the restructuring along with the macroeconomic adjustment will restore debt sustainability. This DSA update assumes a full execution of the authorities' indicative and announced debt treatments. The four debt targets (on program period external debt service relief, post-program GFNs and FX debt service, and debt stock) are met, though with small buffers—in particular on the post program flow targets—highlighting substantial implementation risks. The

[1] Banking sector absorption of government debt as of end-2023 was higher than initially projected, at around 39.3 percent of banking system assets. As of end-2021, the weighted average maturity of Sri Lanka's T-bonds was over 11 years.

flow targets on GFNs and FX debt service limit liquidity risks by limiting debt service to significantly lower levels than in recent history (GFNs in 2013-2022 averaged 23 percent of GDP, and FX debt service averaged 9 percent of GDP).[2] By 2032, domestic and local currency debt are projected to constitute around 54 percent of Sri Lanka's debt (local currency debt was 45.5 percent of total debt in 2022), lowering exchange rate valuation and sudden stop risks. Sri Lanka has traditionally benefitted from large private savings (averaging 33 percent of GDP in 2010-22, and larger than most other emerging and frontier markets). The deep domestic investor base (relatively large banking sector relative to its per capita income levels with assets close to 80 percent of GDP, large captive superannuation funds with assets above 12 percent of GDP and a primary business model of investing in government debt), are a marker of Sri Lanka's domestic debt carrying capacity and are expected to provide mitigation of debt sustainability risks.

Debt Targets Compliance

(In percent of GDP)



Sources: IMF staff estimates and projections.

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[2] As a portion of the flow targets is taken up by debt service on non-restructurable and new debt, often with more concessional nature, the flow targets drive the NPV reduction in debt along with the target on debt stock.

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

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

DSA summary assessment

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

Source: Fund staff.

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

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

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

Figure 2. Sri Lanka: Debt Coverage and Disclosures

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

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

3. Instrument coverage:	Currency & deposits	Loans	Debt securities	Oth acct. payable 2/	IPSGSs 3/

	Basis of recording		Valuation of debt stock		
4. Accounting principles:	Non-cash basis 4/	Cash basis	Nominal value 5/	Face value 6/	Market value 7/

5. Debt consolidation across sectors:	Consolidated	Non-consolidated

Color code: chosen coverage; Missing from recommended coverage; Not applicable

Reporting on Intra-Government Debt Holdings

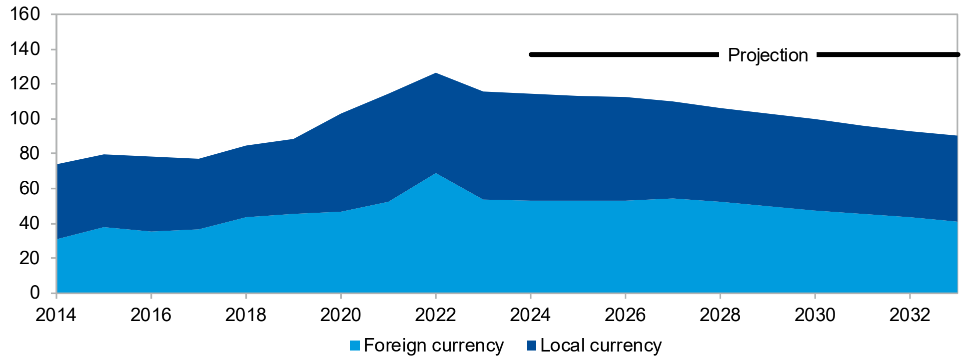
Sectors		Issuer \ Holder	Budget. central govt	Extra-budget. funds	Social security funds	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp	Total
CPS / NFPS / GG: expected / CG	1	Budget. central govt							2742	3687	6429
CPS / NFPS / GG: expected / CG	2	Extra-budget. funds									0
CPS / NFPS / GG: expected / CG	3	Social security funds									0
CPS / NFPS / GG: expected	4	State govt.									0
CPS / NFPS / GG: expected	5	Local govt.									0
CPS / NFPS	6	Nonfin pub. corp.								702	702
CPS	7	Central bank									0
CPS	8	Oth. pub. fin. corp									0
		Total	0	0	0	0	0	0	2742	4389	7131

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

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

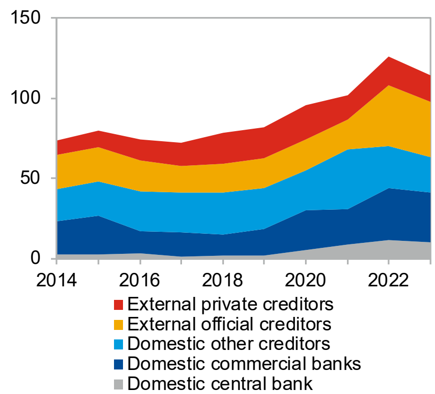
Figure 3. Sri Lanka: Public Debt Structure Indicators

Debt by Currency (Percent of GDP)



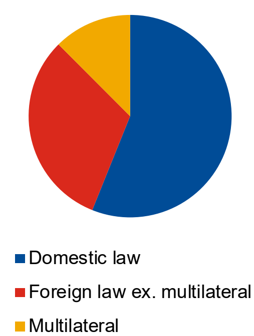
Note: The perimeter shown is central government.

Public Debt by Holder (Percent of GDP)



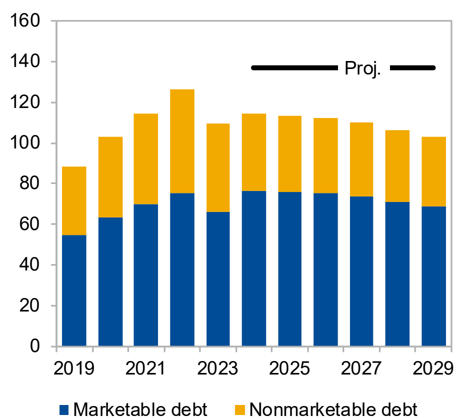
Note: The perimeter shown is central government.

Public Debt by Governing Law, 2023 (Percent)



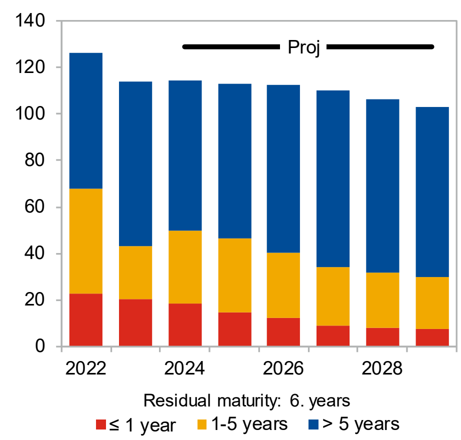
Note: The perimeter shown is central government.

Debt by Instruments (Percent of GDP)



Note: The perimeter shown is central government.

Public Debt by Maturity (Percent of GDP)



Note: The perimeter shown is central government.

Commentary: Accelerating inflation reduced the real value of domestic debt in 2022, while exchange rate depreciation led to a large increase in external and foreign-currency debt. These dynamics reversed partially in 2023, as the exchange rate appreciated, and inflation slowed down. Foreign-law and multilateral law debt account for close to half of Sri Lanka's debt. The debt operation is assumed to rebalance the maturity profile, increasing the residual maturity.

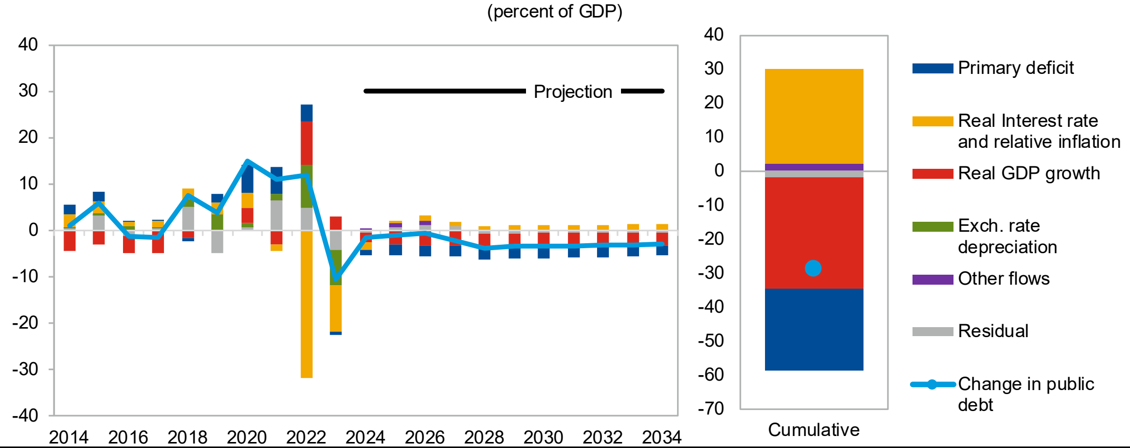
Figure 4. Sri Lanka: Baseline Scenario

(Percent of GDP unless indicated otherwise)

	Prel.	Medium-term projection						Extended projection				
	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034
Public debt	115.7	114.2	113.1	112.5	110.2	106.5	103.0	99.7	96.4	93.2	90.1	87.2
Change in public debt	-10.6	-1.5	-1.1	-0.7	-2.2	-3.8	-3.4	-3.4	-3.3	-3.2	-3.0	-2.9
Contribution of identified flows	-6.4	-1.1	-1.7	-1.7	-3.0	-3.1	-2.8	-2.8	-2.7	-2.7	-2.6	-2.5
Primary deficit	-0.6	-1.0	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3
Noninterest revenues	11.0	13.5	15.0	15.2	15.3	15.3	15.3	15.3	15.3	15.3	15.3	15.3
Noninterest expenditures	10.4	12.4	12.7	12.9	13.0	13.0	13.0	13.0	13.0	13.0	13.0	13.0
Automatic debt dynamics	-5.7	-0.4	-0.4	-0.4	-0.7	-0.8	-0.5	-0.5	-0.4	-0.4	-0.3	-0.2
Real interest rate and relative inflation	-1.1	1.9	2.6	2.9	2.6	2.5	2.7	2.6	2.5	2.5	2.5	2.5
Real interest rate	-10.0	-1.7	0.3	1.3	1.1	1.0	1.2	1.2	1.2	1.2	1.3	1.4
Relative inflation	8.9	3.5	2.3	1.6	1.6	1.5	1.4	1.4	1.3	1.3	1.2	1.1
Real growth rate	3.0	-2.2	-3.0	-3.3	-3.4	-3.3	-3.2	-3.1	-3.0	-2.9	-2.8	-2.7
Real exchange rate	-7.6	…	…	…	…	…	…	…	…	…	…	…
Other identified flows	0.0	0.3	1.0	0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other transactions	0.0	0.3	1.0	0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Contribution of residual	-4.2	-0.4	0.7	1.1	0.8	-0.7	-0.6	-0.6	-0.5	-0.5	-0.5	-0.5
Gross financing needs	27.8	25.00	23.7	20.5	16.6	13.1	11.9	11.7	12.1	12.6	13.4	13.2
of which: debt service	28.5	26.0	26.0	22.8	18.9	15.4	14.2	14.0	14.4	14.9	15.7	15.5
Local currency	26.8	23.5	22.7	19.7	15.8	11.5	10.1	9.6	10.2	10.8	11.7	11.6
Foreign currency	1.7	2.6	3.3	3.2	3.0	3.8	4.1	4.3	4.3	4.1	4.1	3.9
Memo:												
Real GDP growth (percent)	-2.3	2.0	2.7	3.0	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1
Inflation (GDP deflator; percent)	17.5	9.8	6.9	5.4	5.2	5.1	5.0	5.0	5.0	5.0	5.0	5.0
Nominal GDP growth (percent)	14.8	11.9	9.8	8.5	8.5	8.3	8.3	8.3	8.3	8.3	8.3	8.3
Effective interest rate (percent)	8.4	8.1	7.3	6.6	6.3	6.1	6.3	6.3	6.4	6.4	6.6	6.7

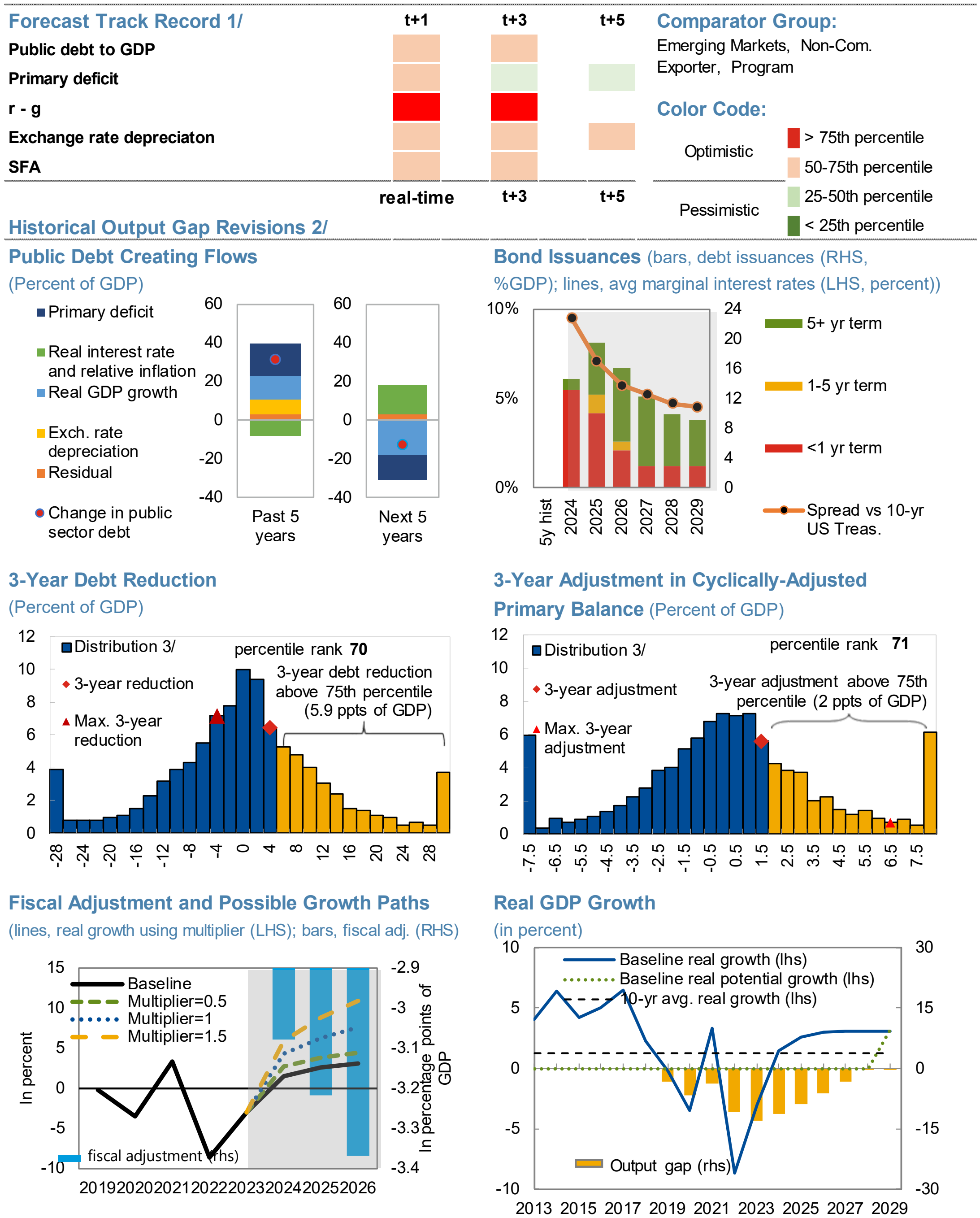
Contribution to Change in Public Debt

(percent of GDP)



Staff commentary: Public debt increased drastically in 2020-22, due to exchange rate depreciation, large fiscal deficits, SOE borrowing, and external borrowing by the Central Bank. In 2023, automatic debt dynamics (exchange rate appreciation, primary surplus, low real interest rate) all contributed to the decline of debt to GDP. In the near term, inflation and contribution from creditors (assumed in 2024, and shown in the residuals) will lead to a drop in public debt. The debt reduction over the longer term rests on continued fiscal discipline and adherence to the macroeconomic adjustment program.

Figure 5. Sri Lanka: Realism of Baseline Assumptions



Commentary: Sri Lanka's forecasts in the past have shown optimism for most debt drivers. Domestic yields are presently high but expected to normalize under the program. The fiscal adjustment efforts are ambitious but backed by identified measures that are needed to restore fiscal sustainability. Growth recovery will be slow due to sovereign default and economic crisis, as well as the associated balance sheet impact.

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

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

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

Figure 6. Sri Lanka: Medium Term Risk Analysis

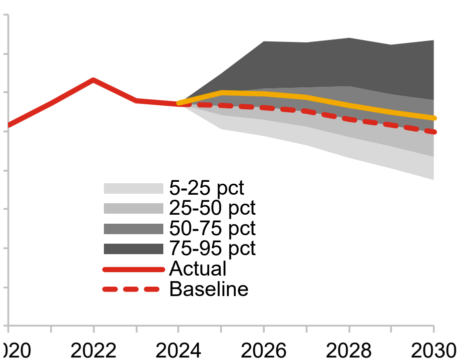
Debt Fanchart and GFN Financeability Indexes

(percent of GDP unless otherwise indicated)

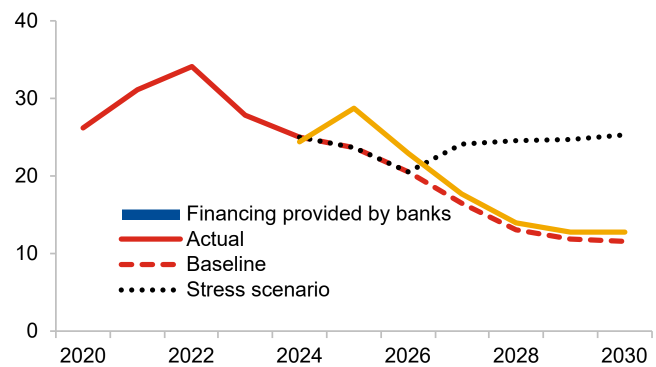
Module	Indicator	Value	Risk index	Risk signal	Emerging Markets, Non-Com. Exporter, Program (0 25 50 75 100)
Debt fanchart module	Fanchart width	72.0	1.0	…	
	Probability of debt not stabilizing (pct)	9.3	0.1	…	
	Terminal debt level x institutions index	65.3	1.4	…	
	Debt fanchart index	**…**	**2.5**	**High**	
GFN finance-ability module	Average GFN in baseline	16.2	5.5	…	
	Bank claims on government (pct bank assets)	40.1	13.0	…	
	Chg. in claims on govt. in stress (pct bank assets)	4.7	1.6	…	
	GFN financeability index	**…**	**20.1**	**High**	

Legend: Interquartile range; Sri Lanka

Final Fanchart (pct of GDP)



Gross Financing Needs (pct of GDP)

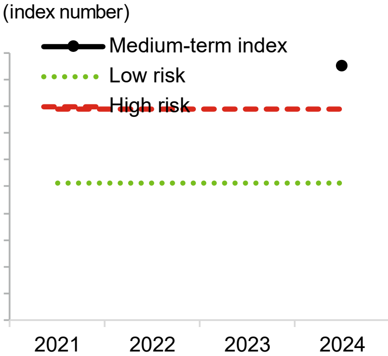


Triggered stress tests (stress tests not activated in gray)

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

Medium-Term Index

(index number)



Medium-Term Risk Analysis

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

Prob. of missed crisis, 2024-2029 (if stress not predicted): 54.5 pct.

Prob. of false alarm, 2024-2029 (if stress predicted): 3.4 pct.

Commentary: Both MT tools (which are now run for 2025-30) point to high level of risks, associated with relatively high levels of debt and GFNs, a strong sovereign-bank nexus, and the economy's vulnerability to large shocks. The banking sector is expected to absorb higher amounts of government debt as a proportion of its assets (now estimated at 40.1% in end-2024) compared to the first review. Sri Lanka is prone to natural disasters such as typhoons and such natural disasters could take both debt and gross financing needs to very high levels, threatening sustainability further. Debt drivers from 2023 are excluded from the historical draws of the debt fanchart in line with the SRDSF guidance note.

Figure 7. Sri Lanka: Long Term Modules

Large Amortization Trigger

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

Overall Risk Indication	

Only the large amortization module is triggered for Sri Lanka. The module shows that the overall risk of large amortizations is low, as GFN to GDP and amortization to GDP ratios in the long term are not significantly different from historical norms (as defined by one standard deviation from the 10-year historical average).

Annex III. Risk Assessment Matrix[1]

Source of Risks	Likelihood	Expected Impact	Policy Response
		Domestic Risks	
Program financing risks arising from lower reserve accumulation, financing shortfalls from external partners, high interest burden, higher-than-expected bank and CBSL recapitalization needs and lower tax revenue collection	High	**H**: Program becomes underfinanced	Depending on the triggers, a combination of actions including (i) higher IFI financing (ii) deeper debt restructuring, (iii) broader and more frontloaded revenue mobilization measures could be considered.
Waning reform momentum especially on revenue mobilization measures ahead of 2024 presidential elections.	High	**H**: Can result in fiscal slippages and weaken confidence and delay access to external financing, slowing economic stabilization.	Enforce program slippages through corrective actions. Streamline and prioritize reforms in line with the program objectives. Continue to engage frequently on program performance through weekly meetings with the authorities.
Delays in addressing banking sector reforms	High	**H**: Weak balance sheets can hinder credit growth and weigh on economic recovery.	Expedite the implementation of banks' recapitalization strategy and legislative changes to strengthen the governance of state-owned banks.
Social unrest, fueled by falling real incomes including from tax hikes and cost recovery pricing in the energy sector, insufficient anti-corruption efforts, and delayed local elections	High	**M**: Can delay or reverse progress of important reforms	Proactively implement inclusive reforms including social security and anti-corruption reforms. Strengthen communication to increase public understanding of the program design and objectives.
Upside inflation risks from stronger economic rebound and second round effects from new tax measures, or exchange rate depreciation pressure.	Medium	**M**: can de-anchor inflation expectations and reduce real income	Monitor inflation development closely and tighten monetary policy if needed to keep inflation anchored around the target level.

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

Source of Risks	Likelihood	Expected Impact	Policy Response
(concluded)			
Slow progress in debt restructuring	High	**H**: Worsen government financing and balance of payments, thus creating financing gaps	Improve government financing through revenue mobilization efforts. Address the BOP pressure by allowing the exchange rate to adjust and seeking higher access to external financing support.
External Risks			
Intensification of regional conflicts. Escalation or spread of the conflict in Gaza and Israel, Russia's war in Ukraine, and/or other regional conflicts or terrorism.	High	**H**: Disrupts trade, remittances, and capital inflows, worsening balance of payments. Can slow recovery.	Support the economy with easing monetary policy and targeted fiscal support. Address the BOP pressure by allowing the exchange rate to adjust and seeking for higher access to external financing support.
Commodity price volatility. A succession of supply disruptions (e.g., due to conflicts, export restrictions, and OPEC+ decisions) and demand fluctuations causes recurrent commodity price volatility, external and fiscal pressures in EMDEs, cross-border spillovers, and social and economic instability.	High	**H**: Increase volatility in inflation dynamics and uncertainties in economic activity	Closely monitor implications to inflation and maintain agility of monetary policies.
Deepening geoeconomic fragmentation. Broader conflicts, inward-oriented policies, and weakened international cooperation result in a less efficient configuration of trade and FDI, supply disruptions, protectionism, policy uncertainty, technological and payments systems fragmentation, rising shipping and input costs.	High	**M:** Slow growth in trade and FDI, increase input costs and inflationary pressure.	Develop corresponding export and FDI promotion strategies in response to the structural change, promote domestic suppliers and improve labor skills. Closely monitor implications to inflation and maintain agility of monetary policies.
Abrupt global slowdown. Global and idiosyncratic risk factors cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and market fragmentation causing sudden stops in EMDEs.	Medium	**M**: Slow trade and capital inflows, with negative spillovers to growth.	Support the economy with easing monetary policy and targeted fiscal support. Address the BOP pressure by allowing the exchange rate to adjust and seeking for higher access to external financing support.

Annex IV. Key Features of Sri Lanka's New PFM Law

1. Powers, duties and functions. The law includes provisions on the roles and powers of the Ministry of Finance and the Secretary to the Treasury.

2. Annual budget process. The law incorporates key elements of budget preparation and approval processes, including roles and responsibilities of the main participants, indicative budget calendar and requirements for budget documentation. A section on budget execution includes strengthened provisions on in-year budget amendments and safeguards governing commitment controls.

3. Fiscal responsibility framework. The law specifies fiscal policy objectives including (i) reducing public debt and maintaining it at sustainable level, (ii) creating and maintaining fiscal buffers against future shocks, and (iii) managing fiscal risks prudently. At the core of the new fiscal rules' framework are a primary balance target (as a percent of GDP) consistent with the debt reduction objective and a primary expenditure ceiling set in the law at 13 percent of GDP. The law requires the preparation and publication of an annual Fiscal Strategy Statement, including a Medium-Term Fiscal Framework (MTFF), which sets the primary balance targets as a medium-term fiscal anchor. The law contains specific accountability mechanisms in cases of non-compliance.

4. Public investment management and PPPs. The law enables stronger management of public investment and PPPs and proposes to integrate the planning of public investment projects and PPPs into the budget process. A new Public Investment Committee will have the authority to recommend a pipeline of viable investment projects.

5. SOEs. Key provisions regulate SOE financial management and reporting. It requires SOEs to submit an annual report, containing the financial statements, investment and business plans, as well as information on guarantees and borrowing.

6. Public procurement. The law focuses on key aspects of procurement related to PFM, such as the requirement for ministries to produce annual procurement plans to facilitate efficient budget preparation and execution, as well as cash management procedures. Other procurement aspects are left to procurement law under preparation.

7. Accounting and reporting. The law strengthens transparency provisions, by requiring each public entity to publish an annual report within six months from the end of a financial year. It requires the minister of finance to prepare and publish fiscal position reports twice a year, as well as before the reading of the budget in Parliament and before general elections. The ministry of finance will publish statements on financial performance, on at least a quarterly basis.

8. Other provisions. The law introduces provisions to modernize and improve cash management, as well as oversight and management of statutory funds.

9. **Precedence**. The PFM law has precedence on PFM matters in the event of a conflict or inconsistency with any other existing laws. Future PFM-related bills should ensure consistency with the PFM law.

Annex V. External Sector Assessment

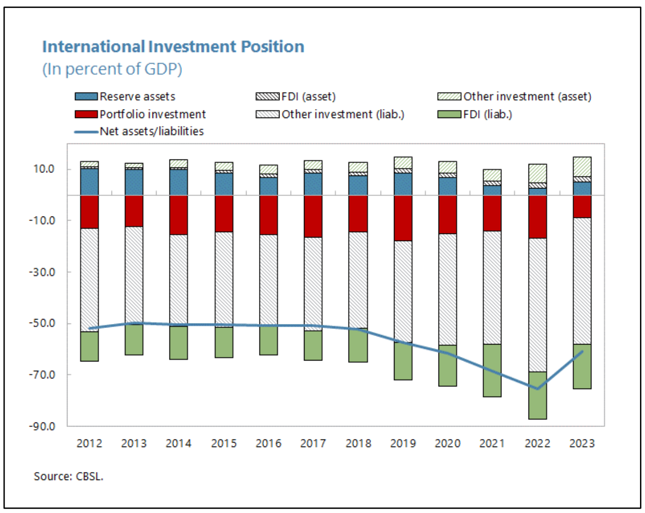
Overall assessment. *The external position of Sri Lanka in 2023 was moderately weaker than the level implied by fundamentals and desirable policies. This assessment is informed by the current account model, based on staff's estimate for the 2023 current account after adjusting for temporary factors. These estimates are subject to large uncertainty. Thus, in addition to model estimates, the overall assessment also takes into account the complex nature of external sector developments and external sustainability challenges that Sri Lanka is currently facing. After the external default in 2022, Sri Lanka has steadily built external reserves in 2023, improved its primary balance, and is on track to restructure its public debt in line with IMF program parameters to restore debt sustainability.*

Potential policy responses. *Even with this progress, significant external sector adjustment needs remain. As the program moves forward, continuing with recommended policies on fiscal consolidation, exchange rate flexibility, and reserve accumulation, along with further structural reforms to boost Sri Lanka's export capacity and encourage FDI in export sectors is key towards rebuilding external sector resilience.*

Foreign Assets and Liabilities: Position and Trajectory

1. Background. Following the sovereign default and BOP crisis in 2022, the authorities embarked on an adjustment program, supported by an IMF EFF arrangement in 2023. Under the program, monetary financing of the government has been curtailed, inflation declined from 70 percent to around 4 percent in 2023, and the primary balance registered a surplus of 0.6 percent of GDP. Under the debt service moratorium, the authorities are only servicing debt to multilaterals and other forms of non-restructurable debt.

2. Sri Lanka's external asset position improved in 2023 but remains precarious with large external liabilities and low assets. After a steady increase in 2018-22 (from 51 percent of GDP on average during 2012-2018 to 75 percent of GDP in end-2022), net external liabilities fell to 61 percent in 2023. This was primarily led by asset accumulation by the CBSL in the form of gross international reserves (US$2.5 billion), and external deleveraging by private banks and businesses (around US$1.2 billion). As at end-2023, 81 percent of external liabilities were in the form of debt, implying significant risks for external sustainability. The government remains the largest debtor, holding 66 percent of total debt liabilities. Successful conclusion of the ongoing public debt restructuring process will help to reduce total external debt stock and improve Sri Lanka's external sustainability.



3. Assessment. The Net International Investment Position (NIIP) improved in 2023 but remains weak. A large negative NIIP (-75% of GDP) and corresponding interest on external debt led to an unsustainable dynamic, leading to the default in 2022. The NIIP improved to about -61 percent of GDP in 2023.

[Assessment year] (% GDP)	NIIP: -	Gross Assets: -	Debt Assets: -	Gross Liab.: -	Debt Liab.: -
2023	-61.0	14.9	5.8	-75.8	-61.4

Current Account

4. Background. The 2023 current account registered a surplus of 3.1 percent of GDP on the back of strong tourism receipts (82 percent yoy growth) and remittances (60 percent yoy growth). In addition, a large goods imports compression (-8.1 percent yoy) partially offset the decline in goods exports (-9.1 percent yoy). The fall in exports was largely driven by a decline in garments and textiles exports (-18 percent yoy), which constitutes over 40 percent of Sri Lanka's goods exports. Two temporary factors supported this positive current account outcome; i) the moratorium on debt service, leading to low interest payments, and ii) import restrictions on goods that used to account for around 10 percent of imports in 2018-19. Sri Lanka's current account had been in deficit for over two decades before 2023 and averaging -2.2 percent of GDP between 2018-22, largely driven by trade deficits. However, these deficits are expected to narrow going forward, driven by a recovery in tourism and remittances that will offset the persistent trade deficits. As a result, the current account balance is projected to average -1.0 percent over 2024-28.

5. The cyclically adjusted CA balance for 2023 is estimated at 0.1 percent of GDP. Cyclical factors contributed a net increase of 3.0 percent of GDP in the current account balance. The slowdown in the Sri Lankan economy in 2023 implied weaker demand for imports and therefore a relatively higher current account balance. This was partially offset by the marginal deterioration in the terms of trade in 2023.

6. This cyclically adjusted CA balance is adjusted for the temporary impact of nonpayment of interest on restructurable debt. As part of the moratorium, Sri Lanka did not service interest on restructurable debt in 2023. However, once the restructuring is completed, Sri Lanka is expected to start paying about 0.7 percent of GDP in interest on such debt (in addition to interest already being paid on non-restructurable debt) from 2024 onwards through the medium term. The adjustment of -0.7 percent of GDP is thus included to avoid artificially inflating the underlying current account surplus.

7. The adjusted CA norm is estimated at 1.0 percent of GDP. The EBA Current Account (CA) model estimates Sri Lanka's current account norm of -0.4 percent of GDP. Staff adjusted this norm to reflect a CA norm that is consistent with the medium-term stabilizing NIIP-to-GDP ratio. Staff estimate that stabilizing the NIIP-to-GDP ratio at -35.0 percent of GDP from the 2022 levels of -73.8 percent would be reflective of a sustainable external position for Sri Lanka following debt restructuring.

8. With a cyclically adjusted CA of -0.6 percent of GDP and an adjusted CA norm of 1.0 percent of GDP, the EBA-based current account gap for 2023 is estimated at -1.6 percent of GDP. Policy gaps (mainly a large fiscal deficit and low FX reserves) account for -0.9 percent of GDP, with –0.8 percent of GDP as residual. This residual can be explained by the various structural and governance impediments that hurt Sri Lanka's external competitiveness. These results suggest that the ongoing fiscal consolidation and reserve accumulation would help close the CA gap over the medium term. Structural and governance reforms – not captured in the model and reflected in the residual – would improve Sri Lanka's competitiveness and the savings-investment balance.

9. Assessment. Staff assesses Sri Lanka's external position to be moderately weaker than the level implied by medium-term fundamentals and desirable policy settings. This conclusion is based on the EBA CA and EBA-lite REER model results—which use a rich set of cross-country information, and accounting for still low reserves and weak NIIP position. The result shows an improvement from 2022, which was assessed to be weaker than implied by fundamentals and desirable policy settings. The improvement is due to the ongoing accumulation of reserves and improved fiscal position. The CA model estimates show that Sri Lanka has a negative current account gap in 2023, around -1.6 percent of GDP, consistent with an REER overvaluation of about 6.6 percent. Similarly, the EBA-Lite REER model shows a negative current account gap of 1.0 percent of GDP. Nonetheless, the degree of overvaluation would be subject to large uncertainty given that the 2023 CA reflects Sri Lanka's extraordinary circumstances, as the country is slowly emerging from a full-fledged BOP and debt crisis.

Model Estimates for 2023 (in percent of GDP)

Sri Lanka: External Balance Assessment: CA Model

(In percent of GDP, unless otherwise noted)

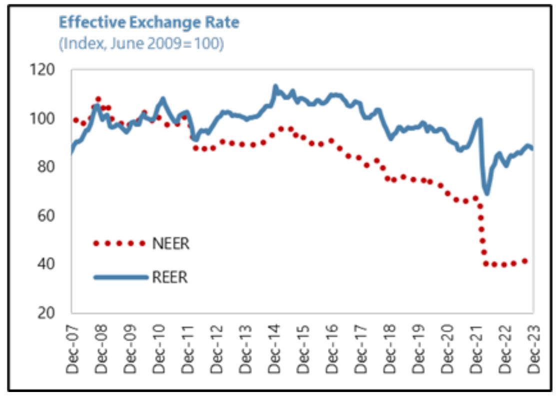
Estimated 2023 CA	**[1]**	**3.1%**
Cyclical contributions	[2]	3.0%
Cyclically adjusted actual CA	**[3] = [1]-[2]**	**0.1%**
Additional temporary factors		-0.7%
Adjustor for interest payments on restructured debt	[4]	-0.7%
Adjusted CA	**[5] = [3]+[4]**	**-0.6%**
CA Norm (from model) 1/	**[6]**	**-0.4%**
Adjustment to the norm 2/	[7]	1.4%
Adjusted CA Norm	**[8]=[6]+[7]**	**1.0%**
CA Gap	**[9]=[5]-[8]**	**-1.6%**
of which Relative policy gap		-0.9%
Fiscal balance		-0.5%
Health expenditure		0.0%
Change in FX reserves		-0.2%
Private credit		-0.2%
Elasticity	[10]	-0.25
REER gap, in % 3/	**[11]=[9]/[10]**	**6.6%**

1/ Cyclically adjusted, including multilateral consistency adjustment.
2/ Adjusted to reflect a CA norm that is consistent with the medium-term stabilizing NIIP-to-GDP ratio.
3/ "-" undervalued ER; "+" overvalued ER

Real Exchange Rate

10. Background. The real effective exchange rate appreciated by around 8 percent in 2023, reflecting favorable changes in inflation differentials and marginal appreciation of the nominal effective exchange rate. The nominal exchange rate appreciated by 12.4 percent during the year, driven by the strong current account trends, which offset capital outflows from banks and businesses.

11. Assessment. Results from the two EBA models point to a REER overvaluation. The estimated current account gap from the CA model points to a REER overvaluation of 6.6 percent. Similarly, the EBA-lite REER model yields a similar REER overvaluation of about 6.4 percent (corresponding CA gap of -1.0 percent of GDP).



EBA-lite REER Model

Ln(REER) EOP 2023	**[1]**	**4.49**
Ln(REER) Fitted	**[2]**	**4.43**
Ln(REER) Norm	**[3]**	**4.43**
Residual	[1]-[2]	0.06
REER Gap 1/	**[4] = [1]-[3]**	**6.4%**
Elasticity	[5]	-0.15
CA gap, % GDP	**[6]=[4]*[5]**	**-1.0%**

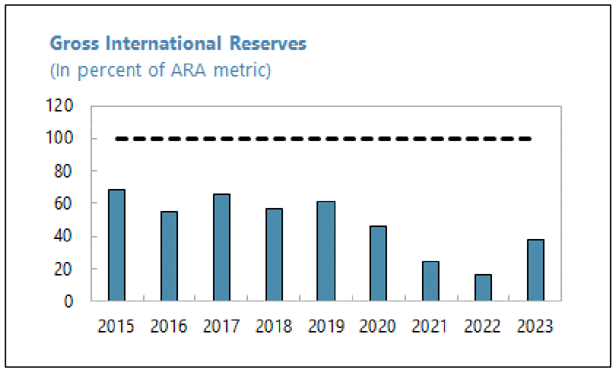
1/ "-" undervalued ER; "+" overvalued ER

Capital and Financial Accounts: Flows and Policy Measures

12. The authorities have started to loosen temporary FX control measures. These measures include import restrictions, exchange restrictions, multiple currency practices (MCPs), and capital flow management (CFM) measures. Over 2020-22, Sri Lanka introduced import restrictions on many goods, and other measures that gave rise to exchange restrictions and MCPs, adopted new CFMs, and tightened existing CFMs. In line with the EFF program, the authorities relaxed most of import restrictions by end-2023, with only restrictions on motor vehicles remaining. Similarly, they relaxed three out of six MCPs, and three out of seven exchange restrictions before the program's first review. By removing these restrictions in a phased manner, the authorities will avoid having such measures substitute for the needed external macroeconomic adjustment. The authorities have been loosening some CFMs that were introduced or tightened since 2020 by increasing the limits on restrictions on capital flows.

FX Intervention and Reserves Level

13. Background. Sri Lanka's international reserve position has improved in 2023 but remains low compared to adequate levels. Gross international reserves (GIR) grew from about US$1.9 billion (1.2 months of prospective imports) at end-December 2022 to US$4.4 billion in end-December 2023 (2.4 months of prospective import s), supported by CBSL's net foreign exchange purchases of around US$1.7 billion. After declining from 62 percent of the Fund's Assessing Reserve Adequacy (ARA) metric at end-2019 to 16 percent at end-December 2022, the end-2023 GIR of US$4.4 billion was equivalent to 37.4 percent of the ARA metric. This is still significantly below the recommended adequacy range of 100-150 percent. Excluding the temporarily unusable assets related to the PBOC swap, usable GIR in 2023 remain at 25 percent of the ARA metric. Net international reserves (program definition) grew significantly but remained negative at US$2.2 billion at end-2023.



14. Assessment. In line with IMF program recommendations, the CBSL has mostly allowed a flexible approach to exchange rate policy in 2023. After depending on various administrative BOP measures to stabilize the exchange rate and preserve reserves in 2022, the authorities entered the IMF program in March 2023. They relaxed the standing CBSL market guidance (to confine daily exchange rate movements in the interbank FX market within a time-varying predefined band around weighted average spot rate of the previous day). Since then, the exchange rate policy has been flexible, and CBSL mostly limited its FX intervention to the buy side, purchasing US$1.7 billion in reserves in 2023. CBSL sold FX (around US$130 million) during June-July 2023 after the volatility driven by the impact of the domestic debt restructuring on banks' FX positions. In addition, it provided US$225 million from its reserves to a state-owned bank for meeting FX position needs. Staff has emphasized to the authorities that such sales should not be used in the future beyond cases of truly disorderly market conditions.

Annex VI. Developments in Debt Restructuring Negotiations

1. Official sector involvement (OSI) includes negotiations with (i) the Official Creditor Committee (OCC), and (ii) China EXIM bank as the major official bilateral creditors. Sri Lanka reached an agreement in principle (AIP) with China EXIM bank on October 11, 2023 and with the OCC on November 29, 2023. Both treatments were assessed by IMF staff as being consistent with program debt targets. Discussions are ongoing to turn these AIPs into finalized agreements. The OCC has discussed with Sri Lanka remaining issues towards finalizing a Memoranda of Understanding.

2. Private Sector Involvement (PSI) includes discussions with the holders of International Sovereign Bonds, and the China Development Bank.

- **International Sovereign Bonds**[1]: Discussions are ongoing with the foreign bondholders' committee (represented by Rothschild and White & Case), where both parties are considering offers that include state-contingent features. The initial bondholder proposal (October 2023) included a macro-linked bond provides for better terms if Sri Lanka's dollar-denominated GDP exceeded certain thresholds above IMF baseline projections at a test date in 2027. In February 2024, the authorities presented to the bondholders' advisors a proposal that included a value recovery instrument. Authorities entered restricted negotiations with the foreign bondholders' committee in late March 2024, and these discussions ended on April 16, 2024, with the publication of a cleansing statement allowing bondholders to resume trading. Key sticking points revolved around the quantum of debt relief in upside states, and instrument design. Staff supported the process by assessing proposals for state contingent instruments in the context of the SRDSF.
- **China Development Bank**: The authorities have exchanged offers with the China Development Bank (CDB) since December 2023. Their advisors visited China in April.
- **Other Creditors**: The authorities have tabled offers to other private creditors, and are having productive discussions.

3. Domestic Debt Operation (DDO) was mostly concluded in 2023 with three portions: (i) maturity extension of T-bonds held by superannuation funds; (ii) exchange of SLDBs and other small FX-denominated bank loans into local currency bonds; and (iii) exchange of T-bills held by CBSL into long term T-bonds. The restructuring of FX loans from CPC (the state petroleum company) held by two state banks remains outstanding. The authorities have designed a treatment with long maturity extensions of these dollar instruments. As the state banks holding these claims have precarious capital positions, the restructuring terms are being contemplated in the context of the holistic bank recapitalization plan.

[1] The litigation brought by Hamilton Reserve Bank is ongoing, and the US court recently granted Sri Lanka's motion for a stay until August 2024.

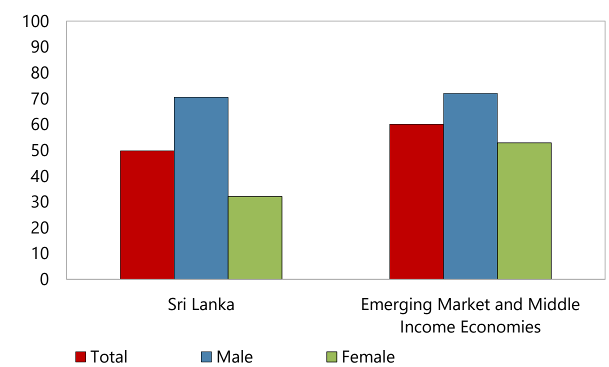
Annex VII. Labor Reform and Implications on Female Labor Force Participation

Improving labor force participation (LFP) will become critical to unlocking Sri Lanka's productive growth potential following the economic crisis. The proposed Employment Act (EA) is a significant step towards improving labor market flexibility, including addressing persistently low female LFP (FLFP). Further efforts are needed to encourage FLFP and help offset the negative impact of the crisis on the labor market.

1. **Low FLFP remains a key constraint**. The closure of businesses, particularly micro, small, and medium enterprises, during the economic crisis led to LFP in Sri Lanka falling to a 10-year low of 49 percent in 2022, lower than the average of 60 percent for emerging markets and middle-income economies (EME) (WB, 2024; ILO, 2024). While male LFP in Sri Lanka was on par with the average for EMEs at around 70 percent in 2022, FLFP was significantly lower for Sri Lanka in 2022 at 32 percent compared to an average of 53 percent for EMEs. Moreover, FLFP has remained persistently low in Sri Lanka at around 32-36 percent over the past decade (DCS, 2023).

Labor Force Participation Rate, 2022

(In percent)

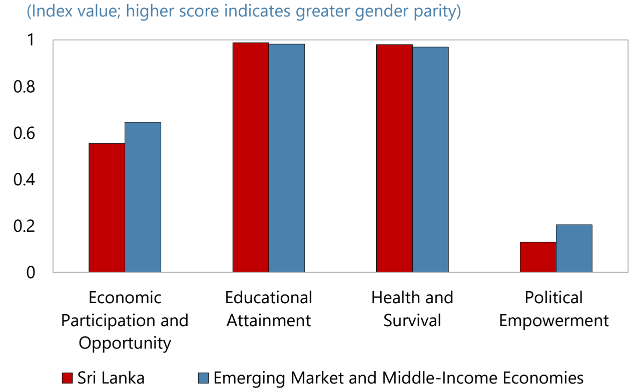


Sources: Department of Census and Statistics of Sri Lanka; World Bank; ILO; and IMF staff estimates

2. **Reducing gender gaps in the labor market could help boost growth and mitigate the impact of population aging**. Sri Lanka performs well in terms of gender parity in education and health with index values close to full parity (World Economic Forum's Global Gender Gap Report 2023). However, Sri Lanka lags in terms of economic participation and opportunity, with an index value of 0.56, compared to an average index value of 0.65 for EMEs[1]. Empirical studies have identified demographics such as higher fertility rates and wider age gaps at marriage and regional effects such as social norms as determinants of gender gaps in labor force participation in South Asia (Jain-Chandra, Kochhar, Newiak, et al, 2018). An analytical study

Gender Gap Indices, 2023

(Index value; higher score indicates greater gender parity)



Sources: World Economic Forum and IMF staff estimates

[1] This sub-index ranges from 0 to 1, with a higher number indicating greater parity.

conducted by the ILO for South Asian countries has shown that reducing gender gaps could increase their GDP growth by over one percentage point. Although country-specific estimates for Sri Lanka are not available, the regional analysis suggests that the increase in Sri Lanka's GDP could be around the same magnitude (IMF, 2018). Other studies have indicated that closing the gender gap over a 50-year horizon could raise incomes by about 21 percent by the year the gap is closed.[2] In addition, simulation results showed that integrating educated women into the Sri Lankan labor market could help offset the economic costs of an aging population in Sri Lanka (IMF, 2018)

3. **Improving FLFP could help minimize the impact of increased labor migration post economic crisis**. Provisional data show that outward labor migration in Sri Lanka had increased by over 50 percent in 2022 compared to 2019 pre-pandemic and pre-economic crisis data (Sri Lanka Bureau of Foreign Employment, 2022). In addition, a household survey conducted by UNICEF and Verite Research found that nearly 25 percent of households had considered migrating abroad during the economic crisis. The Department of Census and Statistics household survey on the impact of the economic crisis in 2023 identified household members starting to work abroad as a coping mechanism. In this context, improving FLFP could help counter the negative effects of increasing labor migration.

Policy Initiatives

4. **The authorities plan to introduce a new EA to unify existing labor laws and adopt new measures to improve LFP**. The EA is expected to be enacted in Q3 2024 and will replace 13 existing labor legislations.[3] A key objective of the proposed EA is to streamline employment terms and conditions and minimize discrimination across different sectors and categories of work (under existing labor laws, working arrangements differ across 44 wage setting bodies, Wages Boards, and employment under the Shop and Office Act). Another key feature of the EA is to improve flexibility of working arrangements by introducing compressed (5-day) work weeks, streamlining leave, simplifying processes related to the termination of employment, and measures to retain employees during a crisis. It will provide for the legal recognition of part-time employment, remote work, training, and apprenticeships.

5. **The EA will introduce a National Remuneration Council for the determination of minimum wage**. The Council will seek to modernize the existing system of minimum wages determined by Wages Board decisions that incorporate collective bargaining and has been criticized for increasing labor costs, impeding employment growth, and shifting of jobs to the informal sector (ILO, 2016). The EA will introduce an electronic wage system and impose restrictions on unfair trade

[2] Cuberes, Newiak, and Teigner (2017). *Gender Inequality and Macroeconomic Performance, Chapter 3, in Women, Work, and Economic Growth Leveling the Playing Field*. Washington, D.C.

[3] The proposed EA will replace 13 existing Acts, notably the Wages Boards Ordinance, Factories Ordinance Act, Industrial Disputes Act, Shop and Office Employees Act, Employment of Women, Young Persons, and Children Act, Termination of Employment of Workmen (Special Provisions) Act, and National Minimum Wage of Workers Act.

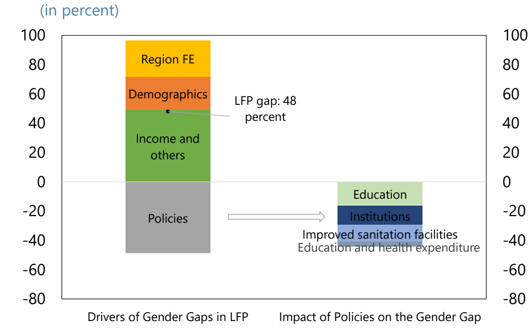
union activity. However, a proper definition of renumeration is needed to avoid policy inconsistencies related to wage determination.

6. **The Gender Equality and Women Empowerment Acts will complement the EA in creating a level playing field and reducing barriers for FLFP**. The Gender Equality and Women Empowerment bills, expected to be approved by parliament in June 2024, seek to implement the National Policies on Gender Equality, Advancement, and Empowerment of Women to ensure equal rights and opportunities for women and protect women from all forms of discrimination through the establishment of a National Commission on Women, a commitment under the WB DPO. The EA will support these efforts by relaxing restrictions on night work for women and legally recognizing domestic workers, who are predominantly female. It will introduce a female quota in executive boards of trade unions for better female representation in the collective bargaining process. In addition, the law will provide for maternity leave irrespective of the employee category, and paternity leave to allow for better burden-sharing within the family unit.

7. **The EA will address gender-based violence and discrimination in line with the National Action Plan (NAP) for the implementation of the UN Security Council's Resolutions on Women, Peace and Security**. A key focus of the NAP is to introduce broad legal and policy reforms to ensure protection of women against gender-based violence and discrimination. In this context, the proposed EA will have a wider scope to address discrimination and sexual violence in the workplace and will update provisions in the areas of occupational safety, health, and welfare of employees.

8. **Further efforts are needed to encourage FLFP**. While revising labor legislation is a welcome development, it is essential that the provisions are in line with international standards including the ILO Conventions ratified by Sri Lanka.[4] There is scope for improving labor market conditions for women based on experience from other countries. Empirical evidence from South Asia indicates that policies to support higher levels of female education, legal rights for women and control of corruption, better infrastructure such as enhanced sanitation facilities and digital services, and higher public expenditure on health and education can narrow gender gaps in the labor market (Jain-Chandra, Kochhar, Newiak, et al, 2018). Other policies to improve FLFP could include expanding affordable childcare facilities, ensuring safe transportation for women, increasing maternity and paternity leave allowance, introducing employment insurance and unemployment benefits, and incorporating gender-responsive budgeting (IMF, 2018).

South Asia: Drivers of Gender Gaps in LFP and impact of policies
(in percent)



Sources: Jain-Chandra, Kochhar, Newiak et al. (2018)

[4] Sri Lanka has ratified 43 ILO conventions, including Fundamental, Governance and Technical Conventions [Ratifications of ILO conventions: Ratifications for Sri Lanka]

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Annex VIII. Resolution of SOE Legacy Debt

1. **The SOE sector in Sri Lanka has been a source of inefficiencies, fiscal risks, and governance vulnerabilities for many years**. SOEs in strategic sectors were typically pricing their products below cost recovery, and the difference was often not covered by the central government budget, leading to growing indebtedness, including to state-owned banks. As a result, the four key SOEs (CPC, CEB, Sri Lanka Airlines (SLA) and Road Development Authority (RDA)) have accumulated significant legacy debt in their balance sheets.

2. **The authorities started to take action to improve the balance sheets of SOEs in 2022**. About US$3 billion of foreign currency debts (US$2.4 billion for CPC and US$0.6 billion for CEB) were transferred to government accounts. Furthermore, debts amounting to Rs. 146.5 billion (about US$0.5 billion) recorded as sub-loans in the CEB financial statements were converted into equity investment by the government in the CEB. In parallel, the adoption of cost-recovery pricing mechanisms for fuel and electricity allowed CPC and CEB to stop making operating losses.

3. **In December 2023, the government completed an equity injection into CEB and SLA totaling about Rs 230 billion.** The injection allowed them to repay their debts to the CPC, which in turn repaid the debt to the Treasury for supplies made through the Indian Line of Credit of almost identical amount, making the whole operation budget neutral. Following the transaction, there are still substantial legacy debts remaining in the balance sheet of key SOEs, which will be resolved following the approach described below.

CEB

4. **CEB's legacy debt was reduced by Rs 156 billion (43 percent of the total) in 2023** (Text Table 1). In addition to the equity injection from the government, CEB used part of the 2023 profits to repay debts. It is reported that an additional Rs 32 billion was paid out of CEB profits in early 2024. The current formula for the electricity tariff includes the interest payments but not the principal repayments for old legacy debts. The authorities have committed to adopt by end-2024 a repayment schedule of CEB's remaining legacy debts, starting in April 2025 (new structural benchmark under the EFF). These repayments will be included in the electricity tariff calculation starting in January 2025, thus ensuring that the restructuring of old CEB debts does not create an additional burden for the central government budget.

CPC

5. **CPC's remaining legacy debt consists of financial obligations to the Iranian Oil Company.** The fuel pricing formula includes a profit margin (between 1 and 4 percent), intended to be used for repayment of legacy debts. Through end-February 2024, profits generated by the fuel pricing mechanism allowed CPC to repay US$35 million out of the total initial amount of US$251 million. It is expected that repayments will continue, at an average rate of US$5 million per month. At this rate, the remaining debt would be repaid in about 4 years.

Text Table 1. CEB Debt, 2022-23

(Rs. billions)

	2022	2023 (prelim.)
"Legacy debt"	**365.8**	**210.1**
Major non-financial creditors	204.6	79.2
Term loans to finance working capital	141.2	110.9
Senior unsecured listed debentures	20.0	20.0
Other debt	**214.8**	**233.7**
Short-term payables	39.8	55.2
Project loans	175.0	178.5
Total debt	**580.6**	**443.8**
Memorandum items:		
Change in legacy debt		-155.7
Of which: through equity injection		-125.3
Of which: from 2023 profits		-30.4

Sources: CEB financial statements; and IMF staff calculations.

SLA

6. **At end-2023, the remaining legacy debt of SLA amounted to US$553 million.** In March 2024, cabinet approved the transfer of US$310 million of SLA loans to the government's balance sheet. This debt was already included in the debt stock restructuring perimeter. The US$175 million of SLA's government-guaranteed foreign currency bonds will be subject to restructuring negotiations with the bondholders. The remaining US$68 million is an overdraft secured by SLA catering, which will be separated from SLA in the process of divestment. In addition to these amounts, SLA also accumulated debt of US$140 million to aircraft lessors, but this is considered part of operational expenses that will be absorbed in the context of the planned divestment of the company (with engagement of the IFC as the authorized transaction advisor).

RDA

7. **Effective from April 1, 2024, the day-to-day operations and management of commercial activities (expressways) have been separated** and assigned to Sahasya Investments Ltd (SIL). The equity of SIL will be provided by the treasury. The treasury will provide gap financing to the SIL to pay the loans obtained to construct expressways. Within six months, RDA and SIL will jointly undertake a legal and financial feasibility study for the transfer of assets. The remainder of the RDA will continue to be financed through budgetary allocations.

Annex IX. Capacity Development

IMF Capacity Development Missions January 2021 - June 2024		
TA/Training Missions	**Providers**	**Date**
Tax Policy		
Tax Policy Reform	FAD	Jun 6-17, 2022
VAT and Excise Tax	FAD/LEG	Jan 12-25, 2023
Property and Wealth Tax	FAD	Jun 30-Jul 13, 2023
Property Taxation in Sri Lanka	FAD	Feb 7-21, 2024
Implementation of VAT Refund Model	FAD	Feb 28-Mar 7, 2024
VAT Refund Model Peripatetic Support	FAD/LTX/STX	May 1-Jul 31, 2024
Revenue Administration		
Strengthening the Large Taxpayer Office	FAD/SARTTAC/STX/LTX	Feb 15-Mar 8, 2022
Implement Large Taxpayer Office	FAD/STX	Apr 4-18, 2022
Tax Administration Diagnostic Assessment Tool (TADAT) training	FAD	Dec 5-9, 2022
TADAT Assessment	SARTTAC (with ADB and WB)	Jan 9-26, 2023
RAMIS	SARTTAC	Mar 7-20, 2023
Guiding the Development of Tax Administration Reform	FAD (with WB)	Jul 3-11, 2023
Medium-term revenue administration reform plan	FAD	Aug 28-Sep 1, 2023
Strengthened revenue administration management and governance arrangements	FAD	Oct 24-26, 2023
Diagnostic assessment on the Customs and the Excise Departments	FAD	Feb 26-Mar 7, 2024
Compliance for high-wealth individuals	FAD	Jan 29-Feb 2, 2024
Guiding the Development of a Revenue Authority	FAD (duty station based)	Nov 6, 2023-Jan 19, 2024
Support to develop a strategic plan to deliver the Revenue Administration Management Information System (RAMIS) version 3.0	FAD/LTX/STX (with WB)	Apr 23-30, 2024
Public Financial Management		
Strengthening macro-fiscal unit: Fiscal Analysis and Forecasting	SARTTAC	Mar 15-26, 2021
Strengthening the Macro-Fiscal Unit	FAD/SARTTAC/STX/LTX	Jan 20-Feb 9, 2022
Macro-Fiscal Unit and MTFF	FAD/SARTTAC/LTX	Sep 19-23, 2022
Fiscal Risks Management	FAD/SARTTAC/LTX	Oct 3-7, 2022
PFM Diagnostic Scoping Mission/ PFM Reform Agenda	FAD/SARTTAC/STX/LTX	Dec 8-10, 2022
Debt Management Office	MCM/LEG (with WB)	Feb 20-Mar 3, 2023
PFM Law (including fiscal rules)	FAD/LEG	Mar 13-23, 2023
Developing a Fiscal Strategy Statement	FAD	Jun 12-16, 2023
Debt Management Law	LEG/MCM/WB	Jun 26-Jul 7, 2023
Finalizing PFM Law	FAD/LEG	Aug 10-21, 2023
Debt Management Reform Plan Implementation	MCM/FAD/STX/WB	Oct 16-25, 2023
Develop rules/regulations for the provision of sovereign guarantees and on-lending	FAD/SARTTAC/WB	Oct 10-16, 2023

IMF Capacity Development Missions January 2021 - June 2024		
Strengthening Cash Management Practice	FAD	Feb 13-23, 2024
Improving Fiscal Reporting	SARTTAC	Apr 2024
Review of Chart of Accounts	FAD/SARTTAC	Apr 15-18, 2024
Strengthening Accounting and Financial Reporting	FAD/SARTTAC	May 2-16, 2024
Monetary and Foreign Exchange Operations		
Monetary Policy Operations	MCM/SARTTAC	Jun 1-Jul 2, 2021
Monetary Policy Frameworks and Implementation	MCM/SARTTAC	Jun 6-17, 2022
Forecasting and Policy Analysis System	ICD/SARTTAC	Nov 28 - Dec 9, 2022; Apr 29 – May 10, 2024
Financial Sector Supervision and Regulation		
Strengthening Technology Risk Management of NBFIs & Building Supervisory Capacity	MCM	May 11-Nov 12, 2021
Financial Sector Stability Reviews (FSSR) Follow-up and Stress Testing	MCM	May 1-12, 2021
FSSR Macroprudential TA/ Resident Advisor	MCM	Aug 1, 2021-July 31, 2023
Liquidity Monitoring	MCM/SARTTAC	Sep 1-9, 2022
Policy discussion on revision of PSSA (first and second phase)	MCM	Oct 24-Nov 4, 2022; Aug 2-8, 2023
Central Bank Balance Sheet	MCM	Dec 1-12, 2022
Macroprudential Policy Tools	MCM	May, June, Sept 2023
Operationalizing Macroprudential Policy Framework	MCM	June 13-20, 2023
Central Bank Liquidity Monitoring and Monetary Operations	MCM/SARTTAC	Jul 4-17, 2023
Strengthening the Risk Assessment of Central Bank of Sri Lanka	MCM	Nov 6-17, 2023
Central Bank Operations Risk Appetite Framework	MCM	Nov 27-Dec 4, 2023
FX market development	SARTTAC	Mar and Jun 2024
Strengthening Debt Management	MCM (with WB)	Apr 23-May 3, 2024
Strengthening Central Bank of Sri Lanka Capacity in Supervision	MCM/SARTTAC/LTX/STX	Apr 29-May 10, 2024
Governance and Anti-Corruption		
Governance Diagnostic Scoping Mission	LEG	Mar 9-14, 2023
Governance Diagnostic Mission	LEG/FAD/MCM/FIN	Mar 20-31, 2023
Statistics		
(1) Government Finance Statistics		
Implementing a Strategy for Broadening the Coverage and Scope of GFS to General Government	SARTTAC	Jan 24-Feb 3, 2022
Expanding Compilation for Consolidated Central Government (CG)	SARTTAC	Jan 23-27, 2023
(2) Real Sector Statistics		
National Accounts: GDP Rebasing	SARTTAC	Mar 29-Apr 23, 2021
National Accounts: GDP Rebasing	SARTTAC	Aug 16-20, 2021
Price Statistics: Updating the Index of Industrial Production and PPI	SARTTAC	Nov 1-26, 2021
National Accounts: GDP Rebasing	SARTTAC	Feb 7-8, 2022
Institutional Sector Accounts - Sequence of Accounts	SARTTAC	Nov 21-25, 2022

IMF Capacity Development Missions January 2021 - June 2024		
Rebasing and Updating the consumer price index (CPI) Weights	SARTTAC	Dec 19-23, 2022
Expand Coverage of the Producer Price Index	STA	Apr 17–28, 2023
Updating the Consumer Price Index	SARTTAC	Mar 11-15, 2024
(3) Monetary and Financial Sector Statistics		
Monetary and Financial Statistics	STA	Feb 26-Mar 8, 2024
Macroeconomic Framework and Foundation Course		
Macroeconomic Framework TA	ICD/SARTTAC	Jan 30 – Feb 3, 2023; Jun 5-9, 2023; Sep 4-5, 2023
Customized Macroeconomic Foundation Course for Central Bank of Sri Lanka (CBSL Staff	SARTTAC	May 27-31, 2024
Regional Training		
Regional Training on Integrated Risk Management in Customs	SARTTAC	Apr 22-26, 2024
Regional Training on Compiling and Using Supply and Use Tables	SARTTAC	Apr 19-May 3, 2024
Regional Training on International Tax Administration	SARTTAC	Apr 1-5, 2024
Regional Training on High Frequency Indicators and Monthly Indicators of Economic Growth	SARTTAC	March 18-22, 2024
Regional Training on Liquidity Forecasting	SARTTAC/ MCM	Mar 4-8, 2024
Regional Training on Effective Leadership for Revenue Administration	SARTTAC	Feb 19-23, 2024
Regional Training on Monetary Policy Implementation	SARTTAC/CDOT	Jan 29 – Feb 2, 2024.
Regional Training on Public Sector Debt Statistics	SARTTAC	Jan 15 – 19, 2024
Regional Training - Quarterly National Accounts	SARTTAC	Dec 11-15, 2023
Regional Training on Effective Collection and Arrears Management in Tax Administration	SARTTAC	Oct 30 – Nov 3, 2023
Regional Training on International Survey on Revenue Administration	SARTTAC	Aug 21-25, 2023
Regional Training on International Trade in Goods and Services	SARTTAC	July 24-28, 2023
Regional Training on Tax Administration Diagnostic Assessment Tool (TADAT)	SARTTAC	Dec 12-16, 2022
Regional training on Taking on Green PFM and Climate Change	SARTTAC/CDOT	Oct 17-20, 2022
Regional Training on Risk Based Audit Techniques	SARTTAC	Oct 17-21, 2022
Regional Training on Sectoral Accounts and Balance Sheets	SARTTAC	Aug 29 – Sep 2_2022
Source: IMF Staff.		

Annex X. Data Issues

Table 1. Sri Lanka: Assessment of Data Adequacy for Surveillance

Data Adequacy Assessment Rating 1/

B

Questionnaire Results 2/

Assessment	National Accounts	Prices	Government Finance Statistics	External Sector Statistics	Monetary and Financial Statistics	Inter-sectoral Consistency	Median Rating
	B	A	A	A	B	B	B

Detailed Questionnaire Results

Data Quality Characteristics						
Coverage	B	A	B	A	B	
Granularity 3/	B		A	A	A	
			B		B	
Consistency			A	A		B
Frequency and Timeliness	A	A	A	B	A	

Note: When the questionnaire does not include a question on a specific dimension of data quality for a sector, the corresponding cell is blank.
1/ The overall data adequacy assessment is based on staff's assessment of the adequacy of the country's data for conducting analysis and formulating policy advice, and takes into consideration country-specific characteristics.
2/ The overall questionnaire assessment and the assessments for individual sectors reported in the heatmap are based on a standardized questionnaire and scoring system (see IMF *Review of the Framework for Data Adequacy Assessment for Surveillance*, January 2024, Appendix I).
3/ The top cell for "Granularity" of Government Finance Statistics shows staff's assessment of the granularity of the reported government operations data, while the bottom cell shows that of public debt statistics. The top cell for "Granularity" of Monetary and Financial Statistics shows staff's assessment of the granularity of the reported Monetary and Financial Statistics data, while the bottom cell shows that of the Financial Soundness indicators.

A	The data provided to the Fund is adequate for surveillance.
B	The data provided to the Fund has some shortcomings but is broadly adequate for surveillance.
C	The data provided to the Fund has some shortcomings that somewhat hamper surveillance.
D	The data provided to the Fund has serious shortcomings that significantly hamper surveillance.

Rationale for staff assessment. Macroeconomic statistics are broadly adequate for surveillance, but weaknesses remain in the timeliness and coverage of certain statistical series. GDP data by expenditure rely mostly on commodity flow methods, and would benefit from more granularity on sector breakdown; for example the breakdown of fixed capital formation into government and private sectors. The quaterly data on GDP expenditure components are also subject to significant revisions. Wage data for the private sector is only limited to the informal sector, and improvement is needed to develop a comprehensive wage database to include both formal and informal private sector. Notwithstanding recent improvements, more granularity is required for below-the-line fiscal financing data and more systematic reporting of fiscal risks is needed. Financial sector data is adequate for surveillance, the accuracy and granuality of CBSL balance sheet reporting have room to improve. The quarterly debt bulletin imporved the timeliness and quality debt statistics, but more summary indicators such as average cost of domestic and external borrowing may help surveillance. Balance of payments data is compiled with a lag, which could be shortened to help

Changes since the last Article IV consultation. NCPI and CCPI indices have been rebased with new weights to account for updated consumer baskets. The quarterly debt bulletin improved debt reporting on public debt**.**

Corrective actions and capacity development priorities. The authorities requested TAs to improve granularity of GDP data by expenditures, and to improve the wage data for the private sector.

Use of data and/or estimates different from official statistics in the Article IV consultation. Third-party indicators such as Transparency International, World Bank Governance Indicators, V-DEM, PSG Group and Open Budget Survey have been used in the selected issues paper.

Table 2. Sri Lanka: Data Standards Initiatives

Sri Lanka subscribes to the Special Data Dissemination Standard (SDDS) since November 2015 and publishes the data on its National Summary Data Page. The latest SDDS Annual Observance Report is available on the Dissemination Standards Bulletin Board (https://dsbb.imf.org/).

Table 3. Sri Lanka: Table of Common Indicators Required for Surveillance

As of April 30, 2024

	Data Provision to the Fund				Publication under the Data Standards Initiatives through the National Summary Data Page			
	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Expected Frequency[6,7]	Sri Lanka	Expected Timeliness[6,7]	Sri Lanka
Exchange Rates	30-Apr-24	30-Apr-24	D	D	D	D	NA	1D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Feb-24	Apr-24	M	M	M	M	1W	1M
Reserve/Base Money	Feb-24	Apr-24	Q	Q	M	Q	2W	1Q
Broad Money	Feb-24	Apr-24	Q	Q	M	Q	1M	1Q
Central Bank Balance Sheet	Feb-24	Apr-24	Q	Q	M	Q	2W	1Q
Consolidated Balance Sheet of the Banking System	Feb-24	Apr-24	Q	Q	M	Q	1M	1Q
Interest Rates[2]	23-Apr-24	30-Apr-24	W	W	D	D	NA	1D
Consumer Price Index	Mar-24	Apr-24	M	M	M	M	1M	1M
Revenue, Expenditure, Balance and Composition of Financing[3]–General Government[4]	Feb-24	Apr-24	Q	Q	A	Q	2Q	1M
Revenue, Expenditure, Balance and Composition of Financing[3]–Central Government	Feb-24	Apr-24	Q	Q	M	Q	1M	1M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Dec-23	Apr-24	Q	Q	Q	Q	1Q	1M
External Current Account Balance	Dec-23	Apr-24	Q	Q	Q	Q	1Q	1Q
Exports and Imports of Goods and Services	Dec-23	Apr-24	Q	Q	M	Q	8W	2M
GDP/GNP	Dec-23	Apr-24	Q	Q	Q	Q	1Q	2Q
Gross External Debt	Dec-23	Apr-24	Q	Q	Q	Q	1Q	1Q
International Investment Position	Dec-23	Apr-24	Q	Q	Q	Q	1Q	2Q

[1] Includes reserve assets pledged or otherwise encumbered, as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds, summary of auction results (bills and bonds) in last 6-month in terms of bid coverage and average rate
[3] Foreign, domestic bank (Bank loans, T-bills and T-bond), and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Frequency and timeliness: ("D") daily; ("W") weekly or with a lag of no more than one week after the reference date; ("M") monthly or with lag of no more than one month after the reference date; ("Q") quarterly or with lag of no more than one quarter after the reference date; ("A") annual.; ("I") irregular; and ("NA") not available.
[7] Recommended frequency of data and timeliness of reporting under the e-GDDS and required frequency of data and timeliness of reporting under the SDDS and SDDS Plus. Any flexibility options or transition plans used under the SDDS or SDDS Plus are not reflected.

Appendix I. Letter of Intent

May 28, 2024
Colombo

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

Dear Ms. Georgieva:

As part of the IMF-supported arrangement, we have undertaken significant reforms to pave our way out of a deep economic and debt crisis. Signs of recovery are emerging, supported by positive GDP growth for two consecutive quarters, reserve build-up and low inflation. Tax revenues have increased and our fiscal adjustment has been sizable. We reached agreements in principle (AIPs) with our official external creditors on a debt restructuring consistent with program parameters, and are in good faith negotiations with our external private creditors.

As of end-December 2023, all quantitative targets (including continuous targets) for the second review were met, except the indicative target (IT) on social spending. All standard performance criteria were observed, all continuous structural benchmarks (SBs) were met and most SBs due by end-April 2024 were either met or implemented with delay.

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

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

With regards to program conditionality, we have completed the required prior action. We are requesting that the IMF Executive Board approves (i) the modification for end-June 2024 QPC on NIR; (ii) the new proposed quantitative targets for the next 12 months, including a new IT setting a ceiling for FX guarantees starting September 2024; (iii) approves the reformulation of SBs to new dates and the setting of new SBs in different areas, (iv) approves the temporary approval of exchange restrictions and multiple currency practices (MCPs), and (v) complete the financing assurances review.

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

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

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

Sincerely yours,

/s/

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

/s/

Nandalal Weerasinghe
Governor
Central Bank of Sri Lanka

Attachments

Memorandum of Economic and Financial Policies

Technical Memorandum of Understanding

Attachment I. Memorandum of Economic and Financial Policies

I. Context and Macroeconomic Developments

1. We remain fully committed to the economic reform program supported by the extended arrangement under the EFF. The IMF Executive Board approved the first review of Sri Lanka's four-year EFF program on December 12, 2023. The program continues to prioritize restoring macroeconomic stability and debt sustainability, mitigating the economic impact on the poor and vulnerable, safeguarding financial sector stability, and strengthening governance and medium-term growth potential.

2. Signs of economic activity are emerging. Following our decisive monetary policy actions, inflation declined rapidly since 2022 despite an uptick earlier this year due to food inflation and new fiscal measures. The recovery pace is picking-up across sectors and reflects stronger consumption and private investments while the financial system remains vulnerable. Tax revenue increased substantially in 2023 amid the economic recession but needs to rise further to allow the government to continue providing essential services in a sustainable manner. Our external debt restructuring negotiations have advanced and will be finalized soon to ensure a path to debt sustainability. Deep-rooted governance issues and structural impediments need to be addressed with a comprehensive anti-corruption and growth-enhancing reform agenda. Our commitments under this economic program will help restore confidence, which would in turn help stabilize the economy and foster higher and more inclusive growth.

- Real Gross Domestic Product (GDP) growth turned positive (1.6 percent y-o-y) in Q3-2023 after 6 consecutive quarters of contraction and increased to 4.5 percent y-o-y in Q4-2023. After the contraction of 2.3 percent in 2023, the economy is projected to expand at 2.0 percent in 2024, followed by gradual convergence towards the growth potential of around 3 percent over the medium term.

- Inflation decelerated rapidly from the peak of nearly 70 percent in September 2022 down to 1.5 percent in April 2024.

- Despite weak exports growth, the current account is estimated at a surplus of 3.1 percent of GDP in 2023 driven by large import compression and strong growth in remittances and tourism receipts. These trends, along with significant IFI disbursements, are estimated to have offset financial account outflows during the year from banks and businesses. As a result, the CBSL was able to build reserves in 2023, through net purchases of US$1.7 billion, bringing the total stock of gross international reserves to US$4.4 billion at end-2023. In 2024, a small current surplus is expected, as strong tourism growth will offset the increase in imports. Fiscal adjustment, recovery in tourism, and competitiveness gains through a flexible exchange rate will support a small non-interest current account deficit (compared to the historical average) after remaining import restrictions are unwound, facilitating rebuilding reserves. As investor confidence is restored, FDI flows are expected to resume in the medium-term.

- The primary balance improved by 4.3 percentage points of GDP from a deficit of 3.7 percent of GDP in 2022 to a surplus of 0.6 percent in 2023, well above our targeted deficit of 0.7 percent. This improvement reflects in part increased tax revenue from 7.3 percent of GDP in 2022 to 9.8 percent in 2023. However, our interest bill remained larger than expected in 2023 due to uncertainty from the debt restructuring, partially eroding the positive impact of the primary balance adjustment. The overall fiscal deficit stood at 8.3 percent of GDP.

II. Economic Program

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

4. We continue to implement the ambitious reform agenda under the EFF. We have already implemented policies including on tax reforms, cost recovery energy pricing, and social safety nets. At end-December 2023, all continuous quantitative performance criteria (QPCs) were observed and all QPCs and indicative targets (ITs) were met, except for the IT on social spending. Structural benchmarks (SB) by end-April 2024 were either met or implemented with delay, except for the operationalization of the BSTA, the submission of the PFM bill to Parliament, the enactment of the asset recovery bill, and we are committed to addressing the remaining gaps (¶17, 19, 32).

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

5. We will lock in the revenue overperformance from 2023. The 2024 Budget targets a primary surplus of 0.8 percent of GDP in 2024 and is consistent with program targets **(structural benchmark)**. Given the stronger-than-expected revenue outturn in 2023, we expect approved measures underpinning the 2024 budget to raise tax revenue to 12.3 percent of GDP, 0.2 percentage point higher than at the first review. Locking-in this overperformance will reduce the needed revenue-based adjustment in 2025 and partially compensate for the lost revenue gains from the property tax in 2025 (¶9). We remain committed to executing spending in line with the approved budget allocations and expect the primary surplus to reach 1 percent of GDP in 2024 **(quantitative performance criterion)**.

6. We remain committed to ensuring our public finances remain sustainable for 2025 and beyond. We will continue to target a central government primary surplus of 2.3 percent of GDP by

2025 and in subsequent years. We will also continue to ensure that annual budgets approved by Parliament are consistent with program parameters including the targets on the primary balance, revenues, and non-interest expenditure and that needed revenue measures requiring legislative amendments are approved by Cabinet by end-September of the preceding year (**structural benchmarks**). Additional quantitative targets will continue to ensure our commitment to (i) increase tax revenue collection (**quantitative performance criterion**), (ii) reduce the stock of budget expenditure arrears to zero (**quantitative performance criterion**), (iii) a ceiling on the issuance of treasury guarantees (**indicative target**), (iv) a new ceiling on new treasury guarantees on FX borrowing **(new IT).** We remain committed to refraining from any tax policy or administrative measures that may erode tax revenue and from any fiscal measure that may result in deviations from the agreed fiscal path under the program.

7. We will continue with revenue mobilization reform to sustain our fiscal consolidation. We remain committed to raising the tax ratio to at least 14 percent of GDP by 2026. Staying the course on revenue mobilization is important given the still-large interest bill on restructured debt. We will adopt both tax policy and revenue administration measures to be effective from January 1st, 2025 (¶8, 9 and 10), unless otherwise stated in ¶9, with an expected yield of 1.5 percent of GDP in 2025. These measures would ensure reaching the program revenue objective and the primary surplus target of 2.3 percent of GDP starting 2025.

8. We will adopt tax policy measures for 2025 including to compensate for the shortfalls from the property tax (¶9). We have already obtained cabinet approval of the revenue measures. All measures will be submitted to Parliament by end-June 2024 (**new SB),** and we will obtain parliamentary approval for them by end-July 2024 **(new SB)**. We expect tax policy measures to yield at least 1.2 percent of GDP in 2025. We are committed to adopting measures to partially compensate for the expected shortfalls from the property tax gains, with an expected yield of at least 0.4 percent of GDP as agreed with IMF staff. We are planning to (i) introduce an imputed rental income tax (0.15 percent of GDP) (¶9), (ii) introduce the VAT tax at a rate of 18 percent of GDP on items currently subject to the special commodity levy (which will be removed), and on the supply of digital services (0.08 percent of GDP), (iii) remove the CIT exemption on the export of services (0.04 percent of GDP), and (iv) increase the CIT rate on betting and gaming, tobacco and liquor industries from 40 to 45 percent (0.08 percent of GDP). In addition, we expect to raise about 0.8 percent of GDP from the lifting of import restrictions on motor vehicles (¶31). We also plan to increase the stamp duties on lease contracts from 0.1 to 0.2 percent (0.03 percent of GDP) which would lower transfers to provincial councils and thus lower spending. If the yield from these measures does not fully materialize, we commit to adopt additional measures to compensate for the shortfall.

9. We will promptly initiate preparatory work to introduce an imputed rental income tax, though the expected gains would only fully materialize in 2026. The introduction of the property tax and the gift and inheritance tax by 2025 encountered delays, due to constitutional restrictions on sharing revenues between the central and local authorities and the lack of adequate information on property values. Given these constraints, we will introduce an imputed rental income tax on owner-occupied and vacant residential properties before the beginning of the tax year on April 1st, 2025.[1] An exemption threshold and a graduated tax rate schedule would make this tax highly progressive. The full revenue yield from this tax is estimated at 0.4 percent and would materialize in 2026 (with a partial yield of 0.15 percent in 2025). This yield would still fall short by 1 percent of GDP relative to the expected yield of 1.2 percent of GDP from the property tax envisaged for 2025 onwards. The shortfall is compensated by the new revenue measures with a yield of 0.7 percent of GDP (¶8 and 10) and the revenue overperformance from 2023 (0.2 percent of GDP). We will continue to explore options to implement a tax on property in the medium-term. To ensure that the imputed rental income tax is fully operational by 2026, we will undertake the following measures:

- Establish the first database on estimated current market values by end-December 2024 with immediate efforts to (i) digitize the valuation records held by the government valuation department, starting with municipal councils, finalizing this effort by end-2025, (ii) collect information from a representative sample of 5,000 standard properties that includes key variables, including annual values, latest assessment date, and property type, of all properties in all municipal councils by August 2024 (**new Structural Benchmark**). This would help determine the capital values of these properties.

- Introduce a provisional nationwide digital Sales Price and Rents Register (SPRR) by August 2024. We will ensure that the SPRR is fully established and operational by end-March 2025 and that it is accessible by the IRD, the valuation department, the land registry and the general public (**new structural benchmark**). A fully operational digital SPRR would be the key resource for the assessment of property values and hence the basis for several taxes, including imputed rental income taxation, capital gains taxation, stamp duties, and local recurrent property taxes.

- Improve data-sharing among relevant government entities. We have introduced a gazette notification on March 21, 2024, under the IRA requiring the Registrar General's Department to share all real estate sales information with the IRD. We will also amend the Notaries Act by April 2025 to ensure comprehensive information on each notarized real property contract (which will include the valuation roll, the cadastral number, and a unique tax ID) is automatically fed into the digital SPRR.

10. We will prioritize the implementation of a VAT compliance improvement program in 2025 to detect and deter noncompliance. The overall efficiency of our VAT system remains low, and our VAT compliance remains weak. To address these weaknesses, we will develop a VAT compliance improvement program which would be expected to raise about 0.3 percent of GDP in 2025. This program will identify, assess, and prioritize compliance risks for each taxpayer segment

[1] Imputed rental income is the deemed income that homeowners could earn if they rented out their homes. The tax is imposed on the income of individuals (rather than real property itself) and thus raises central government revenue in accordance with the constitution. A similar tax was previously included in the Inland Revenue Act. No. 10 of 2006. Under this regime, primary residences were exempt and the assessed values for rating purposes were used to determine the base. Given the broad exemption and the use of outdated and downward biased annual values, the tax generated hardly any revenue.

and determine a detailed plan to respond to those risks. It will involve proactive strategies in all aspects of compliance management from taxpayers' education, registration, filing, payment, and risk-based verifications including by reintroducing taxpayer field visits. To this end, we will provide IRD with sufficient additional resources (staffing, funding, transportation etc.) to conduct core operations including field inspections.

11. We will continue implementing revenue administration reforms that strengthen tax compliance. These efforts should improve the perception that the tax system is equitable and treats all taxpayers equally. We are committed to the following measures:

- To improve core tax administration functions, we have introduced and are tracking and reporting 7 Key Performance Indicators related to: (1) payment; (2) filing; (3) reporting; and (4) registration (Appendix II) (**end-March 2024 structural benchmark**). We will add a new KPI as of September 2024 to improve the functioning of the VAT refund system and have agreed with the IMF mission on new targets for all KPIs up to March 2025 **(revised structural benchmark)**. We will share the data on the quarterly KPIs with IMF staff within two months after the end of each quarter as specified in table 2).

- To support digitization efforts, we will obtain cabinet approval by August 2024 of a prioritized, time-bound, and costed Information Technology Strategic Plan to deliver the Revenue Administration Management Information System (RAMIS) (version 3.0) with the needed functionality enhancements and design improvements **(new structural benchmark).**

- To improve tax collections from large taxpayers, the mission will recommend (i) the completion of risk profiling of the largest 100 High Wealth Individuals (HWI) taxpayers by September 2024, and (ii) for IRD to solicit, by end-December 2024, information from 100 profiled HWI taxpayers via questionnaire.

12. We have already initiated work to fix the VAT refund system to ensure the full repeal of the SVAT system by April 2025. In December 2023, cabinet adopted a strategy laying out a gradual multi-step process to fully repeal the SVAT by April 2025 **(structural benchmark)**. We have formed a committee to oversee the SVAT repeal and we will specify its role and responsibilities in coming months working in conjunction with the Risk Management Committee in IRD. Given the tight timeline to repeal the SVAT and transition to a new refund program, IRD will prepare a project management plan with concrete next steps by end-April 2024. In addition, we will expedite the following efforts: (i) identify the exporters that would strictly be eligible for VAT refunds, (ii) extract from IT systems a comprehensive compliance history of eligible VAT taxpayers, (iii) commence risk profiling for exporters, (iv) develop post payment validation and verification procedures and (v) ensure adequate funding for the VAT refund account. We expect to begin testing these new procedures in a limited and controlled manner by September 2024. In parallel, we are also working to ensure that the current foreign exchange repatriation requirements do not create unnecessary delays in the refund process.

13. We have initiated efforts to modernize the IRD. We commit to the following measures: (i) streamline the online portal for simplified individual income tax filing by June 2024; (ii) accelerate outreach to re-register VAT taxpayers who dropped out; and (iii) finalize enhancements of the RAMIS to support the assessment of 2022/23 income tax returns and to administer and assess the Social Security Contribution Levy (SSCL) by end June 2024, with a view to reducing interactions between taxpayers and tax officials. We will more broadly ensure that processing tax collections is only carried out through RAMIS as of June 2024. We have developed a medium-term IRD Modernization Strategy and Implementation Plan with IMF FAD CD assistance and will have it fully documented and endorsed for implementation by end-July 2024.

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

15. Going forward, we will ensure that needed expenditure rationalization measures will not overly rely on capital expenditure cuts so as not to harm long-term growth. We have under-executed our capital expenditure budget since the crisis to contain spending. Whilst this helped meet the primary balance target in 2023, going forward, we will avoid the full adjustment falling on capital spending. Further capital spending cuts, if still needed, will rely on transparent criteria to guide project cancellation decisions in order to mitigate adverse effects on growth and not discourage revenue mobilization efforts. We will take measures to raise public investment efficiency as recommended by the 2018 IMF Public Investment Management Assessment and strengthen the process to prioritize capital projects. We commit to implementing recommendations from the forthcoming World Bank public finance review exercise.

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

- Total actual spending on SSN during 2023 was Rs. 174.1 billion. The full transition to the new Welfare Benefit Payment Scheme (Aswesuma) was not completed by end-December 2023 due to a large number of grievances. We resolved these grievances by end-February 2024 and are in the process of retroactively making cash transfers which were due by December 2023. With the completion of the retroactive cash transfers, we expect the total SSN spending for December 2023 to be about Rs. 190 billion.

- Under the program, we raised the budget allocation of SSN spending to Rs. 205 billion (or 0.7 percent of GDP) in 2024 (**indicative target**) to maintain the real value of cash transfers per household. This SSN spending will cover cash transfers under the Samurdhi/Aswesuma and the three categorical programs (benefits for elderly, disabled, and chronic kidney disease). Samurdhi cash transfers will cease and cash transfers to the categorical beneficiaries will be included under Aswesuma by end-December 2024. Additionally, we are working towards raising and protecting social spending related to nutrition and education (i.e., school nutrition program and nutrition for expectant mothers) over the medium-term.

- We have made continuous progress in improving the Aswesuma scheme. After the scheme was approved by parliament in May 2023 and implemented in July 2023, we were able to assess the next steps to further strengthen the scheme.

  - ***Targeting***. To further reduce exclusion errors, we called for a second round of applications in February 2024 and expect to complete the data verification by June 2024. With the aim of continuing to improve targeting, we will recertify the beneficiaries each year. We will continue to periodically assess the Aswesuma scheme and its design. For this purpose, we plan to use survey data to assess the eligibility criteria, selection methodology, and the economic impact.

  - ***Coverage***. Given the continued economic hardships, in January 2024, the Cabinet approved extending the cash transfers for the transitional and vulnerable groups by another year till end-December 2024. We also expect to increase coverage of Aswesuma up to 2.4 million families by end-2024.

  - ***Adequacy***. Considering the economic conditions of the beneficiaries, we increased the per beneficiary payments of the transitional group as well as the categorical beneficiaries, effective January 2024.

- We obtained Cabinet approval in March 2024 to implement an empowerment program that would target 1.2 million beneficiaries of the Aswesuma program, by providing economic, social, and psychological support to families over a 3-year period. A pilot project targeting 16,000 Aswesuma beneficiaries in all 25 districts was initiated in Q1 2024 with financial support from the Asian Development Bank and the World Bank. We will also amend the relevant Samurdhi regulations to ensure that only Aswesuma beneficiaries are selected for the empowerment program. In 2025, we will increase the total spending on Aswesuma and the empowerment program to Rs. 225 billion. In terms of institutional arrangements, the Ministry of Finance will continue to lead discussions on external financing for SSN programs.

17. To mitigate fiscal risks arising from the energy SOEs, we will continue implementing automatic fuel and electricity pricing mechanisms. Since November 2022, retail fuel prices have been adjusted monthly in line with cost-recovery, and CPC has been consistently profitable. CEB recorded a cumulative profit of Rs 61 billion in 2023. Part of these profits was used to repay Rs 40 bn of CEB’s debts. We revised the electricity tariffs with effect from March 5, 2024, lowering the average tariff by 21.9 percent. This revision takes into account the more favorable projection of the exchange rate and the interest rates, as well as the improved ability of CEB to finance its capital expenditure (primarily to build new generation capacity) from the domestic banking system. We estimate that this downward revision will nevertheless ensure cost recovery for the CEB in the coming months. Going forward:

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

- We will maintain the electricity tariff at its cost-recovery level (overall across different types of final consumers) with quarterly formula-based adjustments on a forward-looking basis in January, April, July and October each year (effective from January 1, April 1, July 1, and October 1, respectively); the CEB will submit tariff revision requests to the Public Utilities Commission of Sri Lanka (PUSCL) by end-October (for January tariff revisions), by end-January (for April tariff revisions), by end-April (for July tariff revisions) and by end-July (for October tariff revisions). We will compensate the electricity sector for providing any residual electricity subsidies with on-budget transfers; and we will use tariff surcharges in the periods between revisions to restore cost recovery in case CEB is making losses (**continuous structural benchmark**). We will monitor CEB's financial performance on a continuous basis and stand ready to increase the tariff as soon as losses emerge, to avoid any additional burden for the central government budget. Later in 2024, we will undertake the dispatch audit of the CEB's operational costs, which would assess the scope for efficiency gains in electricity generation and transmission.

- The full operationalization of the Bulk Supply Transaction Account (BSTA) is encountering delays, as signing of the power purchase agreements and power sales agreements with generation and distribution companies, respectively, is taking longer than expected. We will proceed on the basis of the MOUs signed in lieu of the formal agreements and will fully operationalize the BSTA by end-June 2024, by adopting a formal rule requiring the regulator to use the BSTA to determine the cost-recovery based electricity tariff and government transfer requirement (**revised structural benchmark**). Once fully operational, the BSTA will allow to continuously monitor CEB's buffers and make corrective tariff changes between the formal revisions.

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

- By June 2024, we will introduce legislative reforms making the Minister of Power and Energy responsible for implementing cost-recovery based fuel and electricity price adjustments.

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

19. We have revamped our fiscal rules' framework and broader public financial management (PFM) procedures through a new PFM law. We have finalized the new PFM bill with support from IMF TA and submitted it to Parliament on May 22, 2024 (**prior action**). We will adopt the implementing regulations of the new law by end-December 2025. The PFM law will improve fiscal discipline through an enhanced fiscal rules framework, better transparency and accountability mechanisms, and more efficient budget preparation processes. We will ensure that any future PFM-related bill (including PPP, SOE, procurement and investment bills) is consistent with the PFM law. We will fully integrate PPPs with the public investment management process and ensure that the Ministry of Finance has a strong gatekeeper role for evaluating the viability and affordability of all projects, including PPPs.

20. We will continue to enhance the PFM functions to ensure fiscal transparency and improve budget processes. Up until now, poor budget execution reflected weak expenditure management, which has often led to budget overruns and spending arrears. We are committed to the following PFM measures:

- To provide binding multi-year guidance for the annual budgets, we will obtain Cabinet approval by end-June 2024 of the fiscal strategy statement (FSS) that would include the medium-term fiscal framework (MTFF) **(structural benchmark)**. The FSS will be published, further enhancing the transparency and accountability of our new fiscal rules' framework. We also plan to submit a Fiscal Risk Statement, identifying and discussing the main sources of fiscal risks, alongside the 2025 FSS.

- We will prepare and publish on the MOF website a medium-term PFM Reform Strategy and Action Plan by end-December 2024. This strategy will help prioritize and sequence PFM reforms, to ensure their orderly progress.

- We will continue integrating the MOF's recently established Macro-Fiscal Unit into fiscal policy decision making by clearly defining its roles and responsibilities, and strengthening its macro-fiscal analytical, forecasting, and reporting capacity. With the help of IMF CD, we will also strengthen the capacity of the macro-fiscal unit in the MoF's Fiscal Policy Department by allocating trained staff dedicated to macroeconomic forecasting and research by end-June 2024. This improvement would better enable MoF prepare the medium-term fiscal framework as required under the new PFM bill.

- We will continue to strengthen commitment-based spending controls by introducing a more rigorous IT-based commitment control framework such as an e-procurement system for public investment. ITMIS, a full-fledged IT-based PFM platform, will be expanded in October 2024, when the remaining 13 budget heads will be added to the system. This will enable us to improve the analytical content of in-year budget execution reports.

21. We will press ahead with structural reforms to improve financial viability of SOEs and strengthen their governance. In December 2023, we conducted a budget-neutral transaction that provided additional equity injections into CEB and SLA, allowing them to repay their debts to CPC, almost exactly cancelling the CPC debt to the Treasury already reported in the fiscal accounts.

- To make the CPC more efficient, we allowed the entry of additional private sector firms into the downstream petroleum sector. Three foreign companies have entered the fuel retail sector so far and have started operating 150 fuel stations while another 300 fuel stations will commence operations in the near future, allowing for a more dynamic and competitive environment. In addition, the fuel pricing formula includes a small margin, that allowed CPC to repay US$20 million of the old financial obligations to the Iranian Oil Company in 2023 and another US$15 million in early 2024. This still leaves US$216 million of these obligations, and we expect repayments to continue.

- To improve CEB's efficiency, we are separating the generation, transmission, and distribution businesses. In addition, we plan to settle CEB's remaining legacy debts (incurred prior to 2023), estimated at about Rs. 180 billion as of end-February 2024. By end-December 2024, we will obtain a cabinet approval of the repayment schedule of CEB's legacy debts, starting in April 2025 (**new structural benchmark**). These repayments will be included in the electricity tariff calculation starting in January 2025, thus ensuring that the restructuring of old CEB debts does not create an additional burden for the central government budget.

- We are proceeding with implementation of the draft strategy by the SOE restructuring unit to reform the business model of SLA to make it financially viable, through a divestment strategy (approved by the Cabinet in November 2022). In March 2024, cabinet approved the transfer of US$310 million of SLA loans (which were already included in the program's debt stock perimeter) to the government's balance sheet. The remaining US$175 million of government-guaranteed FX bonds will be restructured. We expect that this improvement of SLA's balance sheet will facilitate its eventual divestment.

- To strengthen the governance of SOEs and enhance their financial transparency, we will: (i) clarify the mandates of key SOEs through Statements of Corporate Intent and hold their management accountable for delivering satisfactory results informed by key performance indicators; (ii) review the framework for selecting SOE board members to ensure that they are qualified and independent; and (iii) ensure that all 52 major SOEs publish their audited financial statements by end-June of the following year. In 2023, audited statements of all but five smaller SOEs were available by end-December. The remaining five SOEs required auditing their statements going back to 2018. We expect to complete that process and publish audited 2023 financial statements of all 52 major SOEs by end-June 2024. We are drafting the SOE law with assistance from the World Bank, which will incorporate many of these transparency and governance requirements. We will ensure that this new law is consistent with the PFM Act and that the government has full authority to exercise financial oversight of SOEs. We will consult with the IMF before submitting the SOE law to Parliament.

22. We will continue to strengthen the framework for SOE borrowing. Throughout the program, we will ensure that new SOE borrowing is limited to the financing of commercially viable activities (e.g., investment projects), whereas subsidies and other quasi-fiscal activities will be remunerated through government transfers. We will also ensure that, except for project loans on-lent by the Treasury and short-term trade financing, there will be no new borrowing in foreign currency for non-financial SOEs with less than 20 percent of revenues denominated in foreign currency. Our new PDM Act (¶25) will lay out the principles and processes for government borrowing and debt management while enhancing the transparency and accountability and institutional arrangements of the borrowing framework. It will establish the requirement of credit risk assessment and the collection of risk-based fees for the issuance and management of loan guarantees and on-lending. We will ensure that the implementing regulations of the law further define guidelines for clear processes and prudent measures for risk mitigation and regular disclosure of guarantees and on-lending including strict eligibility criteria for SOEs. Guarantees on FX borrowing would be allowed on exceptional basis to facilitate IFI financing to SOEs under very strict conditions. Overall, we will ensure that SOEs effectively comply with all reporting requirements to the Ministry of Finance under the PFM and PDM laws. In the meantime, the total outstanding stock of treasury guarantees will continue to comply with the program indicative target and the limit to be set under the PFM Act or related regulations. In addition, we will comply with a ceiling on the issuance of treasury guarantees of FX borrowing as of September 2024 (**new indicative target**). We will also strengthen the governance and oversight of state-owned banks to ensure that their lending to SOEs is guided solely by commercial considerations (¶34).

IV. Restoring Public Debt Sustainability

23. We remain committed to putting public debt onto a sustainable path. Debt negotiations are anchored by the debt sustainability targets established under the EFF program, which include (i) reducing the ratio of public debt to GDP to below 95 percent by 2032, (ii) reducing the central government's annual gross financing needs below 13 percent of GDP, on average, in 2027-32, (iii) reducing the central government's annual debt service in foreign currency below 4.5 percent of GDP in every year in 2027-32, and (iv) closing the balance of payments financing gaps of US$17 billion over the EFF program period. The debt negotiations have progressed as follows:

- We have now concluded nearly all components of the DDO, with debt treatments executed for the outstanding Provisional Advances from the CBSL to the Government and the outstanding Treasury bills purchased by the CBSL in the primary market, superannuation funds' holdings of T-bonds, and holdings of Sri Lanka Development Bonds by resident and non-resident investors. As envisaged, these operations are geared toward providing substantial liquidity relief to the government while minimizing the balance sheet and cash flows implications for domestic creditors to preserve financial stability and social cohesion. We are finalizing our strategies to restructure the remaining FX local law debt originally contracted by CPC to the state banks, with an aim to address the adverse impact on banks' capital and FX net open positions within the program debt targets and observe transparent accounting standards and regulatory treatment.

We are committed to complete this restructuring by August 2024, as part of the completion of the broader bank recapitalization plan (new **structural benchmark**, ¶31).

- In May 2023, we shared with all of our external creditors an indicative debt treatment scenario that is consistent with achieving the aforementioned debt sustainability targets. Our proposed restructuring perimeter includes all FX foreign law debt except for debt to international financing institutions, bilateral currency swaps, and emergency financing credit lines extended in 2022. Since then, the restructuring discussions have intensified. We reached a preliminary agreement with the EXIM Bank of China and an agreement in principle (AIP) with the OCC in 2023. We continue to have close contacts with the two ISB bondholder committees (representing foreign and local holders, respectively), the China Development Bank, and other external creditors.

- We remain committed to making sufficient progress in these restructuring negotiations. In this respect, we are working towards agreeing on the memorandum of understanding (MOU) with the OCC. We are working towards signed bilateral agreements with OCC member countries, and bilateral agreements with China EXIM Bank. We welcome the ISB bondholders' proactive engagement with us and our advisors and the significant progress made in our negotiations with the China Development Bank. These debt treatment agreements are critical towards ensuring a clear path to restoring debt sustainability. We appreciate our creditors' understanding of the importance of reaching debt agreements consistent with the program parameters and in an equitable manner.

- We reiterate our commitment (as communicated in our President's open letter to official bilateral creditors on March 14, 2023) to refrain from resuming debt service payments to any external commercial or bilateral creditor unless it agrees to a comprehensive debt treatment in line with the IMF program parameters, debt sustainability targets, and the comparability of treatment principle. We are also committed to communicating transparently with all our creditors on debt treatments agreed with any creditor or group of creditors and to report regularly our indebtedness to ensure full transparency.

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

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

- Currently, public debt is managed by the CBSL's Public Debt Department, the MOF's External Resources Department and Treasury Operations Department. To improve debt management, we submitted the public debt management law to the parliament on April 26, 2024 to establish a public debt management Office (PDMO) in line with international best practices and will ensure that the PDMO is established by end-December 2024 **(new structural benchmark)** and is fully functional by end-December 2025. This includes hiring key personnel to staff the front, middle, and back offices and executing basic functions on debt issuance, debt reporting and debt strategies within the transitional provisions of the Act. The PDMO will: (i) report to and be accountable to the Ministry of Finance but have significant operational autonomy; (ii) assume overall policy responsibility for debt management by formulating medium-term debt strategies and annual borrowing plans; and (iii) direct the implementation of annual borrowing plans, including taking decisions on auction cut-offs. The PDMO will oversee all domestic and international market-based financing decisions and participate in the evaluation of all debt, derivatives, and guarantees.

- We are committed to improving debt transparency. The MOF commenced publishing a quarterly bulletin of public debt and debt service in February 2023 covering the debt profile as of end-September 2022. The latest one has been published in February 2024 reflecting outstanding debt as of December 2023. We are committed to gradually broadening the quarterly bulletin's coverage to stock and debt service flows of all liabilities and contingent liabilities of the budgetary central government and of extrabudgetary central government units. In line with international best practice, we will issue guidelines regarding the statistical treatment of guaranteed debt of distressed corporations, and the transfer of government liabilities to SOEs, to be approved by Cabinet.

V. Restoring Price Stability and Rebuilding External Buffers

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

- With rapid disinflation in recent months, a key objective of the CBSL is to maintain inflation around its target level of 5 percent (YoY), which will be monitored through the Monetary Policy Consultation Clause (MPCC) with a mid-point at 5 percent (reset at a lower level compared to program request) and inner and outer bands of ±1.5 and 3 percentage points in June 2024 and onwards (**Quantitative Performance Criterion**). A policy consultation will be held with the IMF staff ahead of each Monetary Policy Board meeting. A nonobservance of the inner and outer bands would require completion of a policy consultation with the IMF staff and the IMF Board, respectively (see Technical Memorandum of Understanding).

- Headline and core inflation fell significantly from their peaks of 70 and 50 percent in September 2022 to 3 and 0.8 percent in 2023 Q4 respectively—outside of the MPCC inner band—while currently at 4.3 and 2.7 percent in 2024 Q1. We held consultations with IMF staff on the reasons for the deviation and proposed policy actions. The lower inflation outturn was largely driven by stronger than expected Rupee appreciation and food deflation. Inflation expectations remain broadly anchored at single digit levels.

- Following the 2022 devaluation, the policy rate was hiked by a cumulative 900 basis points. As inflation fell, the policy rates were reduced by 700 basis points between June 2023 and March 2024 and currently stand at 8.5-9.5 percent. The treasury yields (3 months) and the prime lending rate have also fallen significantly from the peak of 30 and 33 percent to 8.76 and 9.68 percent in May 2024, respectively. Broadly speaking, monetary conditions loosened significantly.

- In order to reduce the lending rate and encourage the passthrough of the policy rate to the lending rate, the CBSL imposed caps on interest rates i.e., on pawning facilities at 18 percent, on pre-arranged temporary overdrafts at 23 percent, and on credit cards at 28 percent, per annum, while capping penal interest rate at 2 percent over and above the regular interest rates for all licensed banks. The CBSL also directed banks to reduce lending rates in line with monetary policy. While these regulations aim to expedite the monetary policy transmission in the near term, considering the distortionary impact on credit supply, we have eliminated them in April 2024. We removed the restrictions for banks to access the standing lending facility of the CBSL on February 16, 2024 and removed the remaining restrictions to access the standing deposit facility of the CBSL on April 1, 2024 to enhance monetary policy transmission.

- We will closely monitor inflation risks and carefully calibrate the future monetary policy stance to take account of the implications of (i) the second-round effects of recent tax measures, (ii) the potential exchange rate passthrough in reaction to financial outflows, (iii) banks' NOP as result of debt restructuring, and (iv) relaxing import restrictions.

- Under a flexible inflation targeting framework, enshrined in the new Central Bank Act (CBA), enacted on September 15, 2023, the CBSL will remain prudent and carefully assess and calibrate its policy stance, consistent with its price stability mandate, to maintain inflation around the target. We are committed to sustain the forward-looking real policy rates close to the neutral rate level. During the program period, we stand ready to adjust the policy stance as guided by the inflation forecasts and inflation performance against the MPCC.

26. To support our effort in maintaining inflation at the target levels, we will continue to refrain from monetary financing. The fiscal adjustment, debt relief, and new external financing envisaged under the program will allow budget deficits to be financed in a more sustainable way going forward, without relying on inflationary monetary financing (i.e., direct credit to government to finance budget deficits) that has jeopardized price stability in the past. The reduction in net domestic financing needs of the government and the improvement in the net international reserves position will enable the CBSL to move ahead with its commitment to gradually unwind its remaining large holdings of Treasury securities, in line with monetary policy objectives. The pace of the reduction is informed by the market's estimated capacity to absorb the CBSL's divestment and a need to prevent excessive expansion of the CBSL's balance sheet from rebuilding reserves. The reduction in the CBSL's holdings of Treasury securities and the discontinuation of monetary financing will be monitored by (1) a **quantitative performance criterion** on the ceiling of the CBSL's net credit to the government (NCG) (excluding the CBSL's temporary holdings of treasury securities for short-term monetary operations; see TMU) and (2) a **continuous performance criterion** to ensure no more purchases of Treasury securities from the primary market. The ceiling for the NCG target is set at Rs. 2,720 billion for end-June 2024. The target is set at Rs. 2,560 billion from end-September 2024 and kept flat until end-March 2025. The ceiling for the continuous PC on the new primary purchases of Treasury securities is set at zero. We have also raised domestic borrowing amounts aiming to maintain an adequate cash balance – including a buffer – in order to meet our cashflow needs without reliance on monetary financing.

27. The CBSL will continue to objectively assess the impact of the DDO on its balance sheet by September 2024 ahead of the central government budget preparation and maintain adequate level of capital to conduct monetary policy, in close consultation with IMF staff and external auditors. The CBSL will continue to follow good accounting standards to evaluate and confirm the discount rates applicable for the DDO and the resulting accounting entries in consultation with External Auditors. CBSL will continue monitoring the impact of sterilization beyond the recorded level of losses in the financial statements of the CBSL prepared according to the IFRS. If needed, MOF is committed to boost the equity of the CBSL through a capital injection to reach an adequate capital level. The authorities will consult with IMF staff on the design and implementation of these steps.

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

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

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

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

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

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

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

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

- Over 2020-22 we suspended the import of many non-priority non-critical goods, which helped contain the import bill and relieved BOP pressures but also hurt economic activity. However, the removal of temporary suspension of imports begun in September 2022 with the removal of 707 items and continued with the relaxation of import restrictions on 286 goods in June 2023, followed by relaxation on 325 further goods in July 2023, and 299 goods in October 2023. With the October relaxation, we have removed import restrictions on all items apart from motor vehicles. We provided an initial timeline on the removal of restrictions on motor vehicles to the IMF staff for consultation on May 21 2024; a detailed plan will be finalized by June 15, 2024. This finalized plan is tied to removing tax exemptions on imports of motor vehicles granted to specific groups including civil servants to curb any revenue leakages from the lifting of the restrictions. In order to support the recovery, we will relax restrictions on vehicles used for commercial purposes by June 2024.

- We currently have the following exchange restrictions: (i) prohibitions on converting Sri Lanka Rupees into FX for certain current international transactions (e.g. servicing certain external loans, payment of any income on certain nonresident investments); (ii) the levy of a 2.5 percent stamp duty on credit card transactions abroad; (iii) the levy of a 14 percent remittance tax on nonresidents' profits; (iv) limits on repatriation by nonresidents of proceeds derived from current transactions; (v) the requirement to provide a tax clearance certificate prior to permitting transfers for certain current transactions. We plan to eliminate these restrictions when conditions allow in the later years of the program.

- Based on the IMF's new MCP policy, we have in place two MCPs, (i) the levy of a 2.5 percent stamp duty on credit card transactions abroad; and (ii) the levy of a 14 percent remittance tax on nonresidents' profits. We plan to eliminate these when conditions allow.

- Alongside, since 2020, we had introduced new CFMs and tightened existing CFMs, including on payments made by residents relating to capital transactions outside of Sri Lanka from foreign currency deposit accounts during the pandemic and recent crisis.[2] Out of these, we have removed the surrender requirement for banks on purchases of proceeds from service exports and inward worker remittances and since program approval, relaxed the CFMs related to outward remittances on capital transactions made by residents and outward transfers of funds by emigrants.

- While the mentioned import restrictions, exchange restrictions, MCPs and CFMs could help mitigate FX shortages in the near term, we believe they should not be a substitute for the comprehensive policy package and ongoing macroeconomic adjustment. We are committed to phasing these measures out as macroeconomic situation stabilizes. To this end, we have already revoked some of these restrictions, and will develop a plan by end-May 2024 for the phased removal of these measures during the program period, in line with our commitment at program approval, as we make progress with achieving macroeconomic stability, particularly with respect to the exchange rate, debt sustainability, and financial stability, improved market access prospects, and accumulation of reserves above critical levels.

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

VI. Ensuring Financial Stability

31. We are committed to ensuring a healthy and adequately capitalized banking system and addressing the significant vulnerabilities in the banking system. Banks face elevated credit risk in their private sector loan books, shrinking net interest margin, large exposures to the public sector, and the impact of the debt restructuring (including on their foreign exchange Net Open Positions). A well-capitalized banking sector is critical to sustain economic recovery through the

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

revival of interbank lending, adequate credit supply for both private and public sector, affordable borrowing cost and credit rating upgrade. Against this background:

- The CBSL will take appropriate action regarding banks unable to ensure their viability, beginning with intensifying supervision and imposing prompt corrective actions.

- The MOF will complete the restructuring of SOEs FX debt mainly comprising of CPC debt by August 2024 (**new structural benchmark**). The restructured terms of new instruments will be consistent with the DSA targets. The potential impact on the NoP and capital of two state banks will be assessed objectively by CBSL in consultation with the IMF team. The valuation of the restructured instruments will be consistent with sound valuation principles and assessed by the CBSL. We are committed to a restructuring treatment that would avoid creating significant net open position problems for banks or destabilizing the FX market and the program's reserve accumulation goals. MoF will inject capital (if needed) to the affected banks upon the execution of restructuring to preserve the capital adequacy of the state-owned banks that can't raise sufficient capital in the market.

- The CBSL completed the assessment of the recapitalization plans of the four remaining banks two months ahead of schedule on December 29, 2023. Following on from the plan developed by the authorities for restructuring and recapitalization of the nine largest domestic banks, the five largest banks submitted capital and net open position restoration plans by end-January and the remaining four banks by March 2024. For the five largest banks, the CBSL has reviewed these plans to assess their credibility and required changes where necessary and completed the review of the plans for the remaining four banks by April 2024. Taking into account CPC and other FX loans restructuring and AQR adjustment, government capital injections required under those plans into the two largest state-owned banks will be completed by end-August 2024 (**structural benchmark**). These will address the capital shortfalls identified by the CBSL's October 2023 assessment, updated where necessary to reflect final debt restructuring terms, updated collateral valuations and changes in exposures for loans assessed by the AQR, and changes in provisioning and capital. For the remaining seven banks, if they are unable to implement their plans as agreed, further action (government capital injection with appropriate conditions or other intervention as set out in the authorities' recapitalization plan) will be taken by end-December 2024 (**structural benchmark**). CBSL will consult with IMF staff on this assessment. Capital injections will be provided in the form of marketable government securities. Going forward, the CBSL will continue to monitor the capital positions of banks on the basis of forward-looking stress tests and stands ready to impose capital requirements under Pillar 2 of the Basel capital standards, as needed. MOF stands ready to provide additional recapitalization funds, if needed, for these purposes as a last resort at the latest by the next Budget after the capital shortfall has been identified. Future capital raising plans for both private and public banks will be in line with the recapitalization plans agreed with CBSL.

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

- The recent temporary Parate law suspension will not be renewed after it expires in December 2024 because it negatively affects banks' ability to recover value from non-performing loans and thus reduces banks' capacity to provide private credit.

32. The frameworks for financial sector supervision and crisis management are being strengthened. Parliament approved the Banking (Special Provisions) Act in July 2023 to strengthen key elements of the CBSL's crisis management powers. Amendments to the Banking Act that are consistent with IMF recommendations were approved in principle by Cabinet in June 2023 and the final approval of the Cabinet was obtained in January 2024. The amendments to the Banking Act, due for end-January 2024, were approved by Parliament on April 2, 2024 (**Structural Benchmark**). The full implementation of the amendments to Banking Act, due for end-March 2024, will be completed by June 2024 **(Structural Benchmark).** The Banking (Special Provisions) Act and amendments to the Banking Act will strengthen: (i) the resolution authority mandate of the CBSL, as well as powers, tools, and appropriate funding mechanisms for resolution of distressed financial institutions; (ii) the deposit insurance framework – including appropriate backstop funding arrangements from the government – and the regime for liquidation of banks; (iii) regulatory standards in areas including bank licensing, bank ownership, consolidated supervision, the capital and liquidity framework, large exposures and related party transactions, requirements, and recovery planning and early intervention powers; and (iv) regulation and supervision of state-owned banks (¶33). For non-bank deposit-takers the CBSL has already reduced regulatory arbitrage on non-performing loan classification and capital requirements. The review of the Finance Business Act will take further steps to minimize regulatory arbitrage. In parallel, staffing of the Bank Supervision Department and the structure, staffing, and funding of the Resolution and Enforcement Directorate in the CBSL will be strengthened to ensure they are able to effectively carry out their expanded responsibilities. The CBSL updated its framework for provision of Emergency Loans and Advances (ELA) for banks in November 2022 and the new CBSL Act effected on September 15, 2023, enables a similar framework to be extended to other financial institutions regulated and supervised by CBSL; liquidity provision to these Non-Bank Finance companies by the deposit insurance fund will be ended.

33. We will strengthen the resilience and governance of state-owned banks. The amendments of the Banking Act ensure state-owned banks meet the same regulatory requirements as private banks, including on large exposures, related party lending, appointment of directors and key management personnel and governance. The existing large exposure will be reduced within the transition period specified in the Banking Act. The supervision requirements by the CBSL will be no less stringent than those for private banks. The Cabinet adopted and published a framework prepared in consultation with IMF and WB staff to strengthen the governance of state-owned banks, requiring their boards to have a majority of independent members, and nominations for board and senior management to be made by the banks' nomination committees following open search procedures with clear requirements for independence and professional experience on May 27, 2024 **(structural benchmark)**. Clear mandates will be defined to ensure that state-owned banks are run at arm's length from the government, lend to SOEs on a commercial basis and within standard prudential limits on concentration risk and foreign currency lending.

VII. Reducing Corruption Vulnerabilities

34. We are committed to advancing governance and anti-corruption reforms as a central pillar of our program. Based on the recommendations in the Governance Diagnostic report, published on September 30, 2023, we developed and published a Government Action Plan on February 29, 2024 **(structural benchmark)** to implement priority recommendations, with special attention to the following areas to set the stage for broader reform agenda. The Action plan will be updated and published annually, and the implementation performance will be reviewed on a quarterly basis.

- **Anticorruption (AC) Legal Frameworks and Institutions**. The new AC Act, enacted in August 2023, significantly strengthens the asset and income declaration framework and CIABOC (Commission to Investigate Allegations of Bribery or Corruption)'s investigative power. The Constitutional Council developed rules for appointing CIABOC Commissioners that established an open and transparent process to ensure selected candidates met the highest levels of professionalism, ethical conduct, and integrity. These rules were published in the Gazette in December 2023 **(structural benchmark)**. The anti-corruption legal framework needs to be further strengthened with more comprehensive asset recovery provisions law in compliance with FATF standards and in consultation with the IMF, which will be enacted within the Proceeds of Crime legislation by November 2024 **(revised structural benchmark)** with the delay from April 2024 to accommodate needed public consultation and technical work. Rapid operationalization of the AC Act will be critical to address current corruption vulnerabilities associated with the lack of an effective mechanism to review and publish asset declarations by public officials, and to investigate and prosecute corruption cases. In this regard, we are committed to publish a strategic plan for the CIABOC, in consultation with the IMF, describing its mission, objectives, timebound actions for operations, and a monitoring framework, together with submission of CIABOC's annual budget, (based on the new strategic plan) by October 2024. **(new structural benchmark**). The CIABOC will publish asset declarations for senior officials in line with the AC Act by July 2024 **(structural benchmark)**.

- **Tax Policy**. Over the years, the Strategic Development Projects (SDP), Board of Investments (BoI), and Port City Acts have granted a wide range of tax exemptions to some investors with no specific or transparent criteria or process. In order to minimize revenue losses and curb corruption risks, we are no longer providing any tax exemptions or incentives, and we are also no longer approving new projects under the SDP Act as of December 2023. We will submit to

Parliament by end-February 2025 amendments to the SDP act, with IMF technical assistance, that will introduce transparent, rules-based eligibility criteria, to increase the effectiveness of granted tax incentives, and to limit the duration for which incentives can be granted (**new structural benchmark**). We have evaluated all existing SDP, BOI and other contracts and published a report detailing the exemptions that have been provided and the value of all tax, regulatory, and other exemptions. Should we consider new tax proposals to attract investments, we will consult with IMF staff prior to their implementation.

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

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

- **Financial Sector Oversight**. With the amendments to the Banking Act (¶32), we enhanced the regulation and supervision of financial institutions' corporate governance, especially the assessment of board and senior management fitness, propriety, and effectiveness in line with international standards and best practices. In the meantime, the cabinet adopted and published a framework prepared in consultation with IMF and WB staff to strengthen the governance of public banks, requiring their boards to have a majority of independent members, and nominations for board and senior management to be made by the banks' nomination committees following open search procedures with clear requirements for independence and professional experience on May 27, 2024 **(structural benchmark)**.

- **Public Asset Oversight and Management.** We are committed to strengthening the regulatory framework that oversees and manages public assets. We will (i) study options to develop a government policy on criteria for allocating rights to public assets, with clear requirements for transparency, competition, and information provision to the public and a timeline to bring existing laws and regulations in compliance with the policy; and (ii) amend the National Audit Act by September 2024 to enable the Auditor General to levy fines on officials, including Chief Accounting Officers, who fail to fulfill their responsibilities in overseeing and managing the public assets[3].

- **AML/CFT.** Following the AML/CFT National Policy for 2023-2028 developed based on the National ML/TF Risk Assessment (NRA) result, we are mobilizing the AML/CFT regime to address the illicit finance risks and to prepare for the comprehensive AML/CFT assessment by the Asia Pacific Group on Money Laundering in 2025. We are working towards strengthening the AML/CFT legal framework, as part of the AML/CFT National Policy, focusing on enhancing the transparency of legal persons and arrangements and beneficial ownership requirements to ensure its compliance with the international standards. We are developing amendments to the Companies Act to bring the beneficial ownership framework in line with the FATF standards, for adoption by end-September 2024. Following the adoption of the Proceeds of Crime law, we will focus on measures to improve the effectiveness of ML investigations, prosecutions, and asset recovery, including increasing the number of investigations related to the threats identified in the NRA, developing the confiscation policy guidelines and relevant capacity of the prosecutors, investigators, and judiciary. We will also strengthen the use of financial intelligence to identify potential corruption activities and the cooperation between FIU, law enforcement, and CIABOC to facilitate parallel investigations. We will also improve the risk-based AML/CFT supervision of financial institutions through strengthened supervisory capacity and regular supervisory engagements focused on compliance with beneficial ownership requirements and enhanced due diligence measures for politically exposed persons.

[3] The Auditor General does not have the authority to dismiss officials and mechanisms to do so are complex and difficult.

VIII. Advancing Growth-Enhancing Structural Reforms

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

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

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

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

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

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

IX. Program Risks and Contingency Planning

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

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

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

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

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

X. Program Monitoring and Safeguards

37. Our program will be subject to semiannual reviews with performance criteria, the MPCC bands, and indicative targets set out in Table 1 attached to this MEFP and Technical Memorandum of Understanding (TMU). Completion of the third review will require observance of the quantitative performance criteria for end-June 2024, continuous performance criteria, as specified in Table 1 attached to this MEFP, as well as standard PCs. The reviews will also assess progress toward observance of the structural benchmarks specified in Table 2 attached to this MEFP. The third and fourth reviews of the program will take place on or after October 1, 2024, and April 1, 2025, respectively. We continue to request the use of IMF financing for budget support, and, in this respect, the Memorandum of Understanding between the CBSL and the Ministry of Finance on responsibilities for servicing financial obligations to the IMF continues to apply. We also recognize the importance of the safeguards assessment of the Central Bank which was finalized in February 2023. The recently passed CBA would serve to address some of the identified safeguards issues, and the CBSL has initiated steps to implement other safeguards recommendations.

38. With regards to program conditionality, we also request that the Executive Board approves the:

- **Modification of existing and setting of new Quantitative Targets**. We request an upward revision of the end-June 2024 QPC for NIR from USD -1810 million to -1710 million to lock-in overperformance on reserves accumulation.

- **Change in the reporting date of the quarterly SBs** on the introduction, tracking and reporting of KPIs on tax compliance. We request that the SB reporting is postponed by two months after the end of each quarter to allow us time for data production and preparation.

- **New proposed quantitative targets**: We will adopt a new IT ceiling on FX guarantees as of September 2024, which would help mitigate underlying fiscal risks.

39. We request that the Executive Board completes the financing assurances review and the second review of the EFF arrangement.

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

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

	2023												2024						2025
	end-June				end-Sep				end-Dec.				end-Mar			end-June	end-Sep	end-Dec	March
	QPC	Adj. PC/IT	Act/Prel.		IT	Adj. IT	Act/Prel.		QPC	Adj. QPC	Prel.		IT	Prel.		PC/IT	IT	Proposed PC/IT	Proposed IT
Quantitative performance criteria																			
Central government primary balance (floor, in billion rupees)	-113	-113	31	Met	-160	-160	124	Met	-209	-209	173	Met	70	316	Met	140	220	300	130
Program net official international reserves (Program NIR, floor, end of period stock, in million US$) 1/ 2/	-2,830	-2,901	-1,918	Met	-2,068	-2,772	-2,492	Met	-1,592	-2,423	-2,182	Met	-2,035	-1,368	Met	-1,710	-1,524	-1,338	-1,088
Net credit to the government of the CBSL (ceiling, end of period stock, in billion rupees) 3/	2,890	2,890	2,800	Met	2,840	2,840	2,838	Met	2,800	2,800	2,742	Met	2,800	2,691	Met	2,720	2,560	2,560	2,560
Stock of expenditure arrears of the central government (ceiling, in billion rupees)	0	0	34.5	Not met	0	0	0	Met	0	0	0	Met	0			0	0	0	0
Central government tax revenue (floor, in billion rupees)													750	837	Met	1,500	2,400	3,700	850
Continuous performance criteria (cumulative from beginning of the program)																			
New external payment arrears by the nonfinancial public sector and the CBSL (ceiling, in million US$)	0	0	0	Met	0	0	0	Met	0	0	0	Met	0			0	0	0	0
CBSL purchases of government securities in the primary market	…	…	…		…				0	0	0	Met	0	0	Met	0	0	0	0
Monetary policy consultation clause																			
Year-on-year inflation in Colombo Consumers Price Index (in percent) 4/																			
Outer band (upper limit)	34.0	34.0	…		20.0	8.0	…		8.0	8.0			8.0			8.0	8.0	8.0	8.0
Inner band (upper limit)	32.5	32.5	…		18.5	6.5	…		6.5	6.5			6.5			6.5	6.5	6.5	6.5
Actual / Center point	31.0	31.0	23.4	Not met	17.0	5.0	3.8	Met	5.0	5.0	3.0	Met	5.0	4.3	Met	5.0	5.0	5.0	5.0
Inner band (lower limit)	29.5	29.5	…		15.5	3.5	…		3.5	3.5			3.5			3.5	3.5	3.5	3.5
Outer band (lower limit)	28.0	28.0	…		14.0	2.0	…		2.0	2.0			2.0			2.0	2.0	2.0	2.0
Indicative targets																			
Central government tax revenue (floor, in billion rupees)	1,300	1,300	1,199	Not met	2,100	2,100	1,934	Not met	2,550	2,550	2,721	Met							
Social spending by the central government (floor, in billion rupees)	70	70	96	Met	120	120	126.5	Met	187	187	174	Not met	50			100	150	205	55
Cost of non-commercial obligations (NCOs) for fuel and electricity (net of government transfers) (ceiling, in billion rupees) 5/	0	0	0	Met	0	0	0	Met	0	0	0	Met	0			0	0	0	0
Treasury guarantees (ceiling, in billion rupees)	1,700	1,700	1,024	Met	1,700	1,700	1,050	Met	2,100	2,100	1,931	Met	2,100			2,100	2,100	2,100	2,100
Treasury FX guarantees (ceiling, in billion rupees)																	1,275	1,275	1,275

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

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

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

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

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

Sources: Authorities; and IMF Staff.

Table 2. Sri Lanka: Structural Benchmarks		
	Date	**Status**
Fiscal, SOE, and Social Safety Net Reforms		
Programmed Conditionality		
Set retail fuel prices to their cost-recovery levels with monthly formula-based adjustments, and compensate the CPC for providing any fuel subsidies with on-budget transfers	Continuous	Met
Maintain cost-recovery level of the end-user electricity tariff schedule (overall across different types of final consumers) with quarterly formula-based adjustments, on a forward-looking basis in January, April, July and October each year (effective from January 1, April 1, July 1, and October 1 respectively); the CEB submits tariff revision requests to the Public Utility Commission of Sri Lanka by end-October (for January tariff revisions), end-January (for April tariff revisions), end-April (for July tariff revisions) and end-July (for October tariff revisions); compensate the electricity sector for providing any residual subsidies with on-budget transfers; and use tariff surcharges in the interim, in case CEB is making losses	Continuous	Met
Parliamentary approval of the welfare benefit payment scheme and the application of the new eligibility criteria to identify low-income families for receiving welfare benefit payments.	End-May 2023	Met
Cabinet approval of a comprehensive strategy to restructure the balance sheets of the CEB, CPC, Sri Lankan Airlines, and the Road Development Authority, in consultation with IMF staff	End-June 2023	Met
Cabinet approval of revenue measures to support fiscal consolidation during 2024, in line with program parameters	End-July 2023	Not met
Completion of the rollout of the ITMIS, expanding its coverage to all 220 heads (national budget execution agencies)	End-September 2023	Not met
Submission to Parliament for the first reading of the 2024 Appropriation Bill that is in line with program parameters	End-October 2023	Met
Parliamentary approval of the 2024 Appropriation Act and the spending allocations in line with program parameters	End-December 2023	Met
Improve the BSTA to accurately measure the electricity subsidy and start using it to determine the cost-recovery based electricity tariff and government transfer requirement.	End-December 2023	Not met Reformulated

Table 2. Sri Lanka: Structural Benchmarks (continued)		
Create and implement within the LTU a HNWI unit and a design and monitoring unit that includes a strengthened Risk Management Unit	End-December 2023	Met
Obtain Cabinet approval of a reduction in the limit on government guarantees to 7.5 percent of GDP	End-December 2023	Met
Obtain Cabinet approval of a strategy to build a VAT refund system and achieve a full repeal of SVAT, with timeline and intermediate steps	End-December 2023	Met
Submission to Parliament of a new PFM law, based on IMF TA, that will authorize the budget formulation process, roles and responsibilities of relevant agencies, and information and accountability requirements	End February 2024	Not met Prior action for the second review
Introduction, tracking and reporting quarterly KPIs of tax compliance	End-March 2024	Implemented with delay in May 2024
Obtain Cabinet approval of the fiscal strategy statement (FSS) containing a medium-term fiscal framework (MTFF).	End-June 2024	
Cabinet approval of revenue measures requiring legislative amendments to support fiscal consolidation during 2025, in line with program parameters	End-September 2024	Reformulated to end-June 2024
Prior Actions for First Review		
Cabinet approval of quarterly revisions of electricity tariffs, starting in 2024		Met
Cabinet approval of the package of revenue measures		Met
Periodic SBs		
Introduce, track and report revised quarterly KPIs of tax compliance for end-March, end-June, end July and end December of every year (annex IV)	End-August, November, End February 2024 and end-May 2025	
Submission to Parliament for the first reading of the 2025 Appropriation Bill that is in line with program parameters	End-October 2024	
Parliamentary approval of the 2025 Appropriation Act and the spending allocations in line with program parameters	End-December 2024	
Proposed to be reset and Reformulated Conditionality		
Prior Action		
Submission to Parliament of a new PFM law, based on IMF TA, that will authorize the budget formulation process, roles and responsibilities of relevant agencies, and information and accountability requirements		Met

Table 2. Sri Lanka: Structural Benchmarks (continued)		
Proposed SBs		
Submission to Parliament of revenue measures to support fiscal consolidation during 2025, in line with program parameters	End-June 2024	
Parliamentary approval of revenue measures to support fiscal consolidation during 2025, in line with program parameters	End-July 2024	
Fully operationalize the BSTA by adopting the rule requiring the regulator to use it to determine the cost-recovery based electricity tariff and government transfer requirement.	End-June 2024	
Collect information from a representative sample of 5,000 standard properties that includes key variables, including annual values, latest assessment date, and property type, of all properties in all municipal councils	End-August 2024	
Obtain cabinet approval of a prioritized, time-bound, and costed Information Technology (IT) Strategic Plan to deliver RAMIS version 3.0 with the needed functionality enhancements and design improvements	End-August 2024	
Obtain a cabinet approval of the repayment schedule of CEB's legacy debts, starting in April 2025	End-December 2024	
Establish and fully operationalize a digital SPRR that is accessible by IRD, the valuation department, the land registry and the general public	End-March 2025	
Monetary Policies		
Programmed Conditionality		
Parliamentary approval of the new CBA prepared in consultation with IMF staff	End-April 2023	Not met (Implemented with delay on July 21, 2023, long transitory arrangement is remedied with a new continuous PC)
Financial Sector		
Programmed Conditionality		
Prior action for First Review		
Determination by the authorities of the size, instruments, and terms and conditions for potential government recapitalization of viable banks among the five large banks which are unable to close capital shortfalls from private sources.		Met on October 31, 2023

Table 2. Sri Lanka: Structural Benchmarks (continued)		
SBs		
Completion of the AQR component of bank diagnostic exercise for the two largest state-owned banks and the three largest private sector banks	End-April 2023	Not met (Implemented with delay in mid-May, 2023)
Cabinet approval of a full revision of the Banking Act in consultation with IMF staff	End-June 2023	Not met (In progress, reformulated and merged with SB on parliamentary approval by end-January 2024)
Development by the CBSL of a roadmap for addressing banking system capital and FX liquidity shortfalls and intervening in banks assessed to be non-viable.	End-July 2023	Not met (Met with delay on October 10, 2023)
Determination by the government of the size, instruments, and terms and conditions for potential government recapitalization of viable banks that are unable to close capital shortfalls from private sources.	End-October 2023	Met on October 31, 2023
Parliamentary approval for the amendments to the Banking Act consistent with IMF recommendations in MEFP in March 2023.	End-January 2024	Not met Met with delay. Cabinet approval granted on January 29, 2024. Parliamentary approval granted on April 2, 2024
Government and CBSL to develop a detailed recapitalization plan for the remaining four banks	End-February 2024	Met on December 29, 2023
Implementation of the amendments to the Banking Act	End-March 2024	Not met Expected for June 2024
Proposed Conditionality		
Completion of the recapitalization for two largest State-owned banks including the completion of restructuring of CPC FX loans	End-August 2024	
Completion of the recapitalization for private sector banks	End-December 2024	
Establish Public Debt Management Agency (PDMA)	End-December 2024	

Table 2. Sri Lanka: Structural Benchmarks (continued)		
Governance		
Programmed Conditionality		
SBs		
Enact new anti-corruption legislation to harmonize it with the United Nations Convention Against Corruption, in consultation with IMF staff consistent with MEFP.	End-June 2023	Not met. (Implemented with delay on July 19, lacks transparent and merit-based selection process, remedied by new SB)
Publication of the Governance Diagnostic report.	End-September 2023	Met
In line with requirements under the 21st Amendment to the Constitution, the Constitutional Council will develop rules for appointing CIABOC Commissioners that will establish an open and transparent process to ensure selected candidates meet the highest levels of professionalism, ethical conduct, and integrity. These rules will be published in the Gazette by end-December.	End-December 2023	Met
Publish on a semi-annual basis on a designated website (i) all public procurement contracts above Rs. 1 billion, along with comprehensive information in a searchable format on contract award winners; (ii) a list of all firms receiving tax exemptions through the Board of Investment and the SDP, and an estimation of the value of the tax exemption; and (iii) a list of firms receiving tax exemptions on luxury vehicle import.	End-December 2023	Not met Implemented with delay on February 13, 2024.
Publication of a government action plan for implementing recommendations in the Governance Diagnostic report.	End-February 2024	Met
Enact a comprehensive Asset Recovery Law to harmonize it with the United Nations Convention Against Corruption, in consultation with IMF staff.	End-April 2024	Not met Reprogramed to End-November 2024
Cabinet approval and publication of a framework prepared in consultation with IMF staff to strengthen the governance of public banks, requiring their boards to have a majority of independent members, and nominations for board and senior management to be made by the banks' nomination committees following open search procedures with clear requirements for independence and professional experience.	End-June 2024	Met on May 27, 2024
The operationalized Anticorruption commission shall publish asset declarations for senior officials in line with Anticorruption Act.	End-July 2024	

Table 2. Sri Lanka: Structural Benchmarks (concluded)		
Periodic SBs		
Publish on a semi-annual basis on a designated website (i) all public procurement contracts above Rs. 1 billion, along with comprehensive information in a searchable format on contract award winners; (ii) a list of all firms receiving tax exemptions through the Board of Investment and the SDP, and an estimation of the value of the tax exemption; and (iii) a list of firms receiving tax exemptions on luxury vehicle import.		
Proposed Conditionality		
Develop in each revenue department an implementation plan to launch a program of anti-corruption measures to strengthen the Code of Conduct, Internal Affairs department, risk management and automation	End-August 2024	
Publish a strategic plan for the CIABOC, in consultation with the IMF, describing its mission, objectives, timebound actions for operations, and a monitoring framework, together with submission of CIABOC's annual budget, (based on the new strategic plan).	End-October 2024	
Submission to parliament amendments to the SDP Act, with IMF technical assistance, introducing transparent, rules-based eligibility criteria, to increase the effectiveness of granted tax incentives, and to limit the duration for which incentives can be granted	End- February 2025	

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

KPI	Baseline	March 2024 Target	June 2024 Target	September 2024 Target	December 2024 Target	Proposed March 2025 Target
KPI-1.1: Risk Based Audit Shift to data-driven, risk-based audit case selection and assignment, away from discretion-based selection by auditor and/or supervisor.	No cases are currently selected on a systematic, data-driven, risk basis.	10 LTU cases selected in Q1	20 new LTU cases selected in Q2	30 new LTU cases selected in Q3, & 2 percent of new non-LTU cases selected during Q3	40 new LTU cases selected in Q4 & 5 percent of new non-LTU cases in Q4	50 new LTU cases selected in Q1, & 10 percent of new non-LTU cases in Q1
KPI-2.1: Tax Return Filing Compliance of Large Taxpayers This is the percentage of expected tax returns from large taxpayers by the due date: (1) VAT – one-month after monthly or quarterly deadline; (2) PAYE by April 30; (3) CIT by November 30	From 2023 TADAT Assessment (P4.12): On-Time CIT Filing: 93.4 percent On-Time VAT Filing: 82.6 percent Only baseline for PAYE is 23.6 percent but covers all employers not just under LTU control.	85 percent of VAT returns on-time	87 percent of VAT returns on-time & 90 percent of PAYE returns on-time	89 percent of VAT returns on-time	91 percent of VAT returns on-time & 95 percent of CIT returns on-time	95 percent of VAT returns on-time
KPI-2.2: Tax Return Filing Compliance of Non-Large Taxpayers This is the percentage of expected tax returns from non-large taxpayers by the due date.	From 2023 TADAT Assessment (P4.12): On-Time CIT Filing: 32 percent On-Time VAT Filing: 45.5 percent PAYE Filing: 23.6 percent.	48 percent of VAT returns on-time	52 percent of VAT returns on-time & 60 percent of PAYE returns on-time	56 percent of VAT returns on-time	60 percent of VAT returns on-time & 50 percent of CIT returns on-time	65 percent of VAT returns on-time

KPI-2.3: Electronic Filing of Individual Income Tax (IIT) Returns First three quarters will reflect 2022/23 IIT returns, Q4 will reflect 2023/24 IIT return.	From 2023 TADAT assessment (P4.14): 23 percent of IIT returns filed electronically in 2021	30 percent filed electronically	35 percent filed electronically	40 percent filed electronically	50 percent filed electronically	60 percent filed electronically.
New KPI. 2.4: VAT Refunds Demand for VAT refunds by exporters will surge when SVAT is repealed. The refund system must be overhauled to meet legal requirement to issue the refund within 45 days from date of claim.	VAT Refund processing is extremely backlogged with delays of months or years to be processed and paid. True baseline situation will be determined in March during TA to overhaul Refund system prior to SVAT repeal.	Baseline Determined		At least 90 percent of new VAT refund requests received since April 2024 from exporters that have been assessed as low or medium risk are issued within 90 days of filing of the VAT return.	At least 90 percent of new refund requests received since July 2024 from exporters that have been assessed as low or medium risk are issued within 60 days of filing of the VAT return.	At least 90 percent of new refund requests received since October 2024 from exporters that have been assessed as low or medium risk are issued within 45 days of filing of the VAT return – this is the target in the VAT Act that needs to be achieved by IRD by the time SVAT ends.
KPI-3.1: Management of Collectible debt Collectible debt is that portion of arrears owed to IRD that is not subject to dispute and where there is no legal impediment to collection action.	From 2023 TADAT assessment (P5.18): At end of 2021, ratio of collectible debt to annual collections was 13.75 percent, but deteriorated to 15.4 percent by end-2022.	Collectible debt is not above 15 percent of 2024 revenue target	Collectible debt is not above 14 percent of 2024 revenue target	Collectible debt is not above 13 percent of 2024 revenue target	Collectible debt is not above 12 percent of 2024 revenue target	Collectible debt is not above 11 percent of 2025 revenue target

KPI-4.1: VAT Registration	The registered VAT population was nearly 29,000 before the 2019 changes and has fallen to 12,000. IRD seeks to rebuild VAT and SSCL taxpayer base to 20,000 by end-2024	14,000 active VAT and SSCL registered taxpayers	16,000 active VAT and SSCL registered taxpayers	18,000 active VAT and SSCL registered taxpayers	20,000 active VAT and SSCL registered taxpayers	22,000 active VAT and SSCL registered taxpayers

Attachment II. Technical Memorandum of Understanding

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

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

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

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

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

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

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

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

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

h) a monetary policy consultation clause;

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

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

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

l) an indicative target on foreign exchange treasury guarantees (ceiling).

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

I. PERFORMANCE CRITERIA

A. Performance Criterion on Central Government Primary Balance

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

5. For the purpose of program monitoring, the primary balance of the central government on cash basis will be measured as the overall balance of the central government plus the interest payment of the central government. The overall balance of the central government is measured from the financing side, as the negative of the sum of the items listed below. Here, net borrowings refer to gross disbursements minus principal repayments. For 2023, the primary balance of the central government on cash basis measured in this manner was Rs 173 billion (the overall balance was Rs. minus 2,282 billion and the interest payment was Rs 2,456billion).

a) Net borrowings from issuances of Treasury Bills, Treasury Bonds, and loans in local currency. In 2023, the total amount of such net borrowings was Rs. 3,296 billion.

b) Net decreases in the balances (deposits minus overdrafts) of the central government in the banking system. In 2023, the total amount was Rs. minus 655billion (an increase in bank balances).

c) Net increases in CBSL advances, net of changes in central government deposits at the CBSL. In 2023, the total amount was Rs. minus 236 billion.

d) Net borrowings from Sri Lankan Development Bonds (SLDBs) and domestic loans in foreign currency. In 2023, the total amount was Rs minus 393 billion.

e) Commercial borrowings issued under foreign law, including international sovereign bonds and syndicated loans. In 2023, the total amount was Rs 0 billion.

f) Net borrowings from official project and program loans and trade credit lines. In 2023, the total amount was Rs 495 billion.

g) Net borrowings from all other bonds, loans, and advances contracted by the central government. In 2023, the total amount was Rs minus 224 billion.

h) Proceeds from privatization or commercialization of public asset to residents and nonresidents. In 2023, the total amount was Rs 0 billion.

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

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

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

C. Performance Criterion on Central Government Tax Revenue

8. Central government tax revenue refers to revenues from taxes collected by the central government. It excludes all revenues from asset sales, grants, and non-tax revenues. The revenue target is calculated as the cumulative flow from the beginning of the year. For 2023, central government tax revenue defined in this manner was Rs 2,721 billion.

D. Performance Criterion on Net Official International Reserves

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

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

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

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

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

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

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

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

The Following Adjustment Will Apply:

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

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

Compilers and Users. These adjustors will apply to the NIR floor for end-December 2022 and thereafter.

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

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

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

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

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

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

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

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

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

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

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

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

The Following Adjustment Will Apply:

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

II. CONTINUOUS PERFORMANCE CRITERIA

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

17. A continuous performance criterion applies to the non-accumulation of new external payments arrears on external debt contracted or guaranteed by the nonfinancial public sector and the CBSL. The nonfinancial public sector is defined following the 2001 Government Finance Statistics Manual and the 1993 System of National Accounts. It includes (but is not limited to) the central government as defined in paragraph 3 and nonfinancial public enterprises, i.e., boards,

enterprises, and agencies in which the government holds a controlling stake. External payments arrears consist of debt-service obligations (principal and interest) to nonresidents that have not been paid at the time they are due, as specified in the contractual agreements, subject to any applicable grace period. However, overdue debt and debt service obligations that are in dispute will not be considered as external payments arrears for the purposes of program monitoring. Arrears resulting from the nonpayment of debt service, for which a rescheduling or restructuring agreement is being sought, are excluded from this definition. This continuous performance criterion will be monitored continuously by the authorities and any non-observance will be immediately report to the Fund.

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

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

The Following Adjustment Will Apply:

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

H. Other Continuous Performance Criteria

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

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

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

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

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

III. MONETARY POLICY CONSULTATION CLAUSE

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

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

where

t = the month within which the test date is included

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

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

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

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

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

IV. INDICATIVE TARGETS

I. Indicative Target on Social Safety Net Spending

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

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

23. The non-commercial obligations (NCOs) for fuel and electricity refer to the obligations of Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB) to supply fuel and

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

electricity at prices below cost-recovery levels. The indicative target is set on the cost of fuel and electricity NCOs net of government transfers, which corresponds to the cost of the NCOs that are not compensated by the central government budget.

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

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

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

For the test date of end-March 2024:

$$NCO(2023Q4) - G(2024Q1)$$

For the test date of end-June 2024:

$$\{ NCO(2023Q4) + NCO(2024Q1) \} - \{ G(2024Q1) + G(2024Q2) \}$$

For the test date of end-September 2024:

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

$$- \{ G(2024Q1) + G(2024Q2) + G(2024Q3) \}$$

For the test date of end-March 2024:

$$NCO(2023Q4) - G(2024Q1)$$

where

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

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

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

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

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

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

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

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

K. Indicative Target on Treasury Guarantees

27. Treasury guarantees are defined as outstanding debt guarantees issued by the central government. A guarantee of a debt refers to any explicit legal obligation of the central government to service such a debt in the event of nonpayment by the recipient. Treasury guarantees exclude letters of comfort. Outstanding guarantees are defined as the drawn amounts of guaranteed debts. They differ from issued guarantees, which are defined as the total amount of guaranteed debts (including for debts that are not disbursed yet). Treasury guarantees include outstanding treasury guarantees published in the Statement of Contingent Liabilities contained in the Annual Report of the Ministry of Finance. Rupee values for guarantees issued in other currencies will be calculated using the exchange rate for the last day of the calendar year as it appears in the Statement of Contingent Liabilities in the Annual Report of the Ministry of Finance. As of end-2023, the outstanding treasury guarantees were valued at Rs 1,931 billion.

L. Indicative Target on Foreign Exchange Treasury Guarantees

28. Foreign exchange treasury guarantees are defined as outstanding debt guarantees issued in foreign currency by the central government. A guarantee of a debt refers to any explicit legal obligation of the central government to service such a debt in the event of nonpayment by the recipient. Treasury guarantees exclude letters of comfort. Outstanding guarantees are defined as the drawn amounts of guaranteed debts. They differ from issued guarantees, which are defined as the total amount of guaranteed debts (including for debts that are not disbursed yet). Treasury guarantees include outstanding treasury guarantees published in the Statement of Contingent Liabilities contained in the Annual Report of the Ministry of Finance. Rupee values for the FC guarantees will be calculated using the exchange rate for the last day of the calendar year as it appears in the Statement of Contingent Liabilities in the Annual Report of the Ministry of Finance. As of end-2023, the outstanding treasury FX guarantees were valued at Rs 1,304 billion.

V. DATA REPORTING REQUIREMENTS

29. Sri Lanka shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Sri Lanka in achieving the objectives and policies set forth in the Memorandum of Economic and Financial Policies and Letters of Intent. All the program monitoring data will be provided by the Ministry of Finance and the CBSL. For the purpose of monitoring the fiscal performance and expenditure arrears under the program, data will be provided in the format as shown in Tables 3, 4, and 5. For the purpose of monitoring the NCG targets under the program, data will be provided in the format shown in Table 6. For the purpose of monitoring the external sector performance under the program, data will be provided in the format shown in Tables 7 and 8. For the purpose of monitoring the performance against the indicative target on social safety net spending, data will be provided in the format shown in Table 9 on a quarterly basis. For the purpose of monitoring the financial performance of three state-owned enterprises—CEB, CPC, and Sri Lankan Airlines—data will be provided in the format shown in Tables 10, 11, and 12, respectively, on a quarterly basis. For the purpose of monitoring the performance against the indicative target on the cost of fuel NCO (net of government transfers), data will be provided in the format shown in Table 13 on a quarterly basis. For the purpose of monitoring the performance against the indicative target on treasury guarantees, data will be provided in the format shown in Table 14 on a quarterly basis. For the purposes of the assessment of Multiple Currency Practices, data and information on official exchange rate action and impact on rates will be provided, as requested by IMF staff.

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

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

- Liquidity monitoring template, with breakdown by currency (daily)
- LCR template, with breakdown by currency (monthly)

- Net open foreign currency positions (weekly)
- Exposures to the central government and large SOEs (CEB, CPC, SLA, RDA), with breakdown by entity, currency, and instrument (monthly)
- Maturities of exposures to the central government and large SOEs (CEB, CPC, SLA, RDA), (monthly)
- Arrears of state-owned banks (monthly)
- Impairment schedule including breakdown of impairments on public sector exposures (monthly)
- Monthly supervisory returns to CBSL including statements of financial position and comprehensive income (monthly)
- Top 10 largest depositors (quarterly)
- Large exposures exceeding 15 percent of capital (quarterly)
- Capital adequacy template (quarterly)
- Financial soundness indicators (quarterly)
- Daily financial sector data will be provided within one week of the end of the reporting period; weekly data within two weeks; monthly data within four weeks; quarterly data within six weeks.

Table 3. Sri Lanka: Central Government Operations

(In millions of rupees)

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

Table 4. Sri Lanka: Central Government Financing [1]

(In millions of rupees)

	(i) Borrowing/ Cash inflow	(ii) Repayment/ Cash outflow	(iii) Net
1. Domestic financing in local currency			
T-bills 1/			
T-bonds 1/			
Loans			
Deposits and overdrafts at banks			
CBSL advances and deposits			
Other (specify)			
2. Domestic financing in foreign currency			
Sri Lanka Development Bond (SLDB) 1/			
Loans			
Other (specify)			
3. Net foreign financing			
International Sovereign Bonds 2/			
Official project loans			
Official program loans			
Official trade credit			
Syndicated loans			
Other (specify)			
4. Change in Treasury Single Account 3/			
5. Privatization receipts			
Total financing (1+2+3+4+5)			

1/ including net purchases by non-residents
2/ including net purchases by residents
3/ A negative sign means an increase in the TSA and vice versa.

1/ The template has been modified to include the change in the Treasury Single Account as a financing item.

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

(In millions of rupees)

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

1/ as agreed for the purpose of monitoring the program

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

(In millions of rupees)

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

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

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

Table 7. Sri Lanka: Foreign Exchange Cashflows of the Central Bank and the Government 1/
(In millions of U.S. dollars)

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

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

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

(In millions of U.S. dollars)

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

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

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

Budget Code		Total
	Total Social Safety Net Spending 2/ = (1)+(2)+(3)	
	Cash transfers to empower the vulnerable and needy	
102-1-2-040-1501	(1) Aswesuma cash transfers	
102-1-2-040-1501 -033	Cash grant for low income families	
102-1-2-040-1501 -034	Financial support for low income disabled persons	
102-1-2-040-1501 -035	Financial support for elderly (over 70 years of age)	
102-1-2-040-1501 -036	Financial support for elderly (over 100 years of age)	
102-1-2-040-1501 -037	Financial support for kidney patients	
	(2) Transitional (currently not under Aswesuma)	
331-2-2-1-1501	Samurdhi cash transfers	
	(3) Empowerment Program	

1/ In line with the reporting of the Ministry of Finance Annual Report
2/ By January 2025, (2) will be subsumed under (1)

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

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

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

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

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

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

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

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

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

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

(In millions of rupees, unless otherwise noted)

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

Memorandum item:	
Central government current transfers to CP	[x]

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

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

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

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

SRI LANKA

May 29, 2024

STAFF REPORT FOR THE 2024 ARTICLE IV CONSULTATION AND SECOND REVIEW UNDER THE EXTENDED FUND FACILITY, REQUEST FOR MODIFICATION OF PERFORMANCE CRITERION, AND FINANCING ASSURANCES REVIEW—INFORMATIONAL ANNEX

Prepared By

Asia and Pacific Department (in collaboration with other departments)

CONTENTS

FUND RELATIONS

(As of April 30, 2024)

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

General Resources Account:	**SDR Million**	**Percent Quota**
Quota	578.80	100.00
Fund holdings of currency	1,742.77	301.10
Reserve Tranche Position	2.86	0.49

SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	950.21	100.00
Holdings	25.57	2.69

Outstanding Purchases and Loans:	**SDR Million**	**Percent Quota**
Extended Arrangements	1,166.81	201.59

Latest Financial Arrangements:

Type	**Date of Arrangement**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
EFF	03/20/2023	03/19/2027	2,286.00	508.00
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

Overdue Obligations and Projected Payments to Fund[1] (SDR Million; based on existing use of resources and present holdings of SDRs):

			Forthcoming		
	2024	**2025**	**2026**	**2027**	**2028**
Principal	148.71	158.70	148.71	139.91	138.98
Charges/interest	72.11	88.10	80.04	72.71	65.35
Total	220.83	246.80	228.75	212.61	204.33

[1] 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:

Since the February 2023 updated assessment,[2] a new Central Bank Act was enacted where SA recommendations were incorporated, financial risk management was expanded, and steps were initiated to strengthen the internal audit function, including the completion of an external quality assessment. However, in view of the CBSL's weakened equity and the TA received on assessing its balance sheet and monetary operations, the safeguards assessment recommended that the CBSL approves a medium-term plan to strengthen its financial position. Staff will continue to engage with the CBSL on the implementation of remaining recommendations.

Exchange Rate Arrangement:

The *de jure* exchange rate arrangement is classified as free floating, while the de facto exchange rate arrangement is classified as other managed.

Sri Lanka has accepted the obligations of Article VIII, Sections 2 (a), 3, and 4 of the IMF's Articles of Agreement. Sri Lanka maintains exchange restrictions subject to approval under Article VIII, Section (a), arising from (i) prohibitions on converting LKR into FX for certain current international transactions (e.g., servicing certain external loans, payment of any income on certain nonresident investments); (ii) the levy of a 2.5 percent stamp duty on credit card transactions abroad; (iii) the levy of a 14 percent remittance tax on nonresidents' profits; (iv) limits on repatriation by nonresidents of proceeds derived from current transactions; and (v) the requirement to provide a tax clearance certificate prior to permitting transfers for certain current transactions. In addition, Sri Lanka 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 multiple currency practice subject to Fund jurisdiction under Article VIII, Section 3 arising from the following measures (i) the levy of a 2.5 percent stamp duty on credit card transactions abroad; (ii) the levy of a 14 percent remittance tax on nonresidents' profits.[3]

[2] The updated assessment found that the CBSL's audit and financial reporting functions meet international standards, and the internal control environment is anchored in a strong compliance culture; however, some functions require continued modernization.

[3] Sri Lanka previously maintained multiple currency practices arising from the following measures i) the levy of a 2.5 percent stamp duty on credit card transactions abroad; (ii) the levy of a 14 percent remittance tax on nonresidents' profits, and iii) the official exchange rate calculated based on the previous day's transactions in the interbank FX market and used for CBSL's FX transactions with the government (IMF Country Report No. 23/408 for 1st review under EFF). In line with the revised MCP policy that became effective on Feb 1, 2024, all MCPs maintained by members under the previous MCP policy are considered eliminated as of Feb 1, 2024. The following MCPs are considered eliminated as of July 1 2022: MCPs arising from (i) FX auction if the auction meets the criteria set out in Paragraph 15, (ii) official exchange rate if its calculation conforms to the conditions specified in Paragraph 16 and (iii) illegal parallel markets as specified in Paragraph 17 of the "Review of the Fund's Policy on Multiple Currency Practices—Proposals for Reforms" (2022).

Article IV Consultation:

It is proposed that that the next Article IV Consultation with Sri Lanka takes place in accordance with the Executive Board decision on consultation cycles for members with Fund arrangements.

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.
- LEG: A ROSC on AML/CFT was completed and the report published in 2008.

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.

Governance Diagnostics:

- A Governance Diagnostic Assessment was conducted jointly by LEG, FAD, MCM and FIN in March 2023, and the report was published in September 2023. This was the first Governance Diagnostic Report in Asia, which provided an impetus for the authorities to publish their own governance action plan, building on the report's recommendations.

Capacity Development:

- FAD. TA has been provided in a wide range of areas. In the area of tax policy, TA was provided to review tax policy, reform the VAT and excise tax, implement the new property tax, and implement a VAT refund system. In the area of revenue administration, TA was provided to guide the development of tax administration reform (jointly with the World Bank), strengthen the large tax office, improve compliance of high-wealth individuals, guide the development of a revenue authority, support the Revenue Administration Management Information System (RAMIS), diagnose the customs and excise departments. In the area of public finance management, FAD assisted the authorities to draft the Public Finance Management Bill (jointly with LEG), strengthen the macro-fiscal unit at the MoF (jointly with SARTTAC), draft a fiscal strategy statement, manage fiscal risks, and strengthen cash management. Sri Lanka has also benefited from the placement of a resident tax advisor to IRD and resident public finance management advisor to MoF.
- ICD. TA missions on macroeconomic forecasting, including further 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. ICD has also provided TA on macroeconomic framework to MoF and CBSL.

- LEG. LEG assisted the authorities in drafting the new Central Bank Act. LEG also provided technical assistance on producing the Governance Diagnostic Report. Jointly with FAD and MCM, LEG provided support on the drafting of various legislations and regulations.

- MCM. TAs have been provided to the Central Bank of Sri Lanka to enhance the effectiveness of monetary policy implementation and improve liquidity forecasting (jointly with SARTTAC). CBSL also received TA to enhance supervision capacity and strengthen macroprudential framework. TA missions also helped to analyze the CBSL's balance sheet, develop a risk appetite framework, and diagnosed the payments and settlements systems. MCM (jointly with LEG and the World Bank) has provided technical assistance in drafting the Public Debt Management Law and establishing the Debt Management Office.

- 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).

- SARTTAC: SARTTAC has provided extensive TA and training in a wide range of areas. In the real sector, TA was provided in price statistics as well as rebasing national accounts statistics, accompanied with training on compiling quarterly national accounts and high frequency indicators of economic growth. In the fiscal sector, TA was provided to strengthen the new Macro-Fiscal Unit at the Ministry of Finance, improve revenue mobilization, strengthen fiscal reporting, and improve government finance statistics. Training on the fiscal issues centered on international tax administration, risk management, arrears management, and Tax Administration Diagnostic Assessment Tool (TADAT). In the monetary sector, SARTTAC has provided Sri Lanka with TA to enhance the effectiveness of monetary policy implementation and strengthen liquidity forecasting (jointly with MCM) as well as enhance FX market development. In coordination with ICD, SARTTAC continued to support the CBSL in incorporating FPAS into the decision-making processes. Regional macro training courses included macro-diagnostics, financial programming, and financial sector supervision.

Resident Representative

Since October 2022, Ms. Sarwat Jahan has been the resident representative based in Colombo. The Resident Representative Office in Colombo was established in 1977.

RELATIONS WITH OTHER INTERNATIONAL FINANCIAL INSTITUTIONS

Information on the activities of other IFIs in Sri Lanka can be found at:

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

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

Statement by Krishnamurthy V. Subramanian, Executive Director for Sri Lanka and PKG Harischandra, Alternate Executive Director to Executive Director
June 12, 2024

On behalf of Sri Lankan authorities, we wish to extend our sincere gratitude to the Board, management, and staff for their invaluable support during this critical period. We deeply appreciate the tireless work of the mission team, led by Mr. Peter Breuer and Ms. Katsiaryna Svirydzenka, and their constructive engagement with authorities and stakeholders. The quality of work delivered by the staff has been extraordinary, even in the face of the unparalleled complexities of Sri Lanka's program. Our authorities wish to thank all creditor nations, represented by the Official Creditor Committee (OCC) co-chaired by France, India, and Japan, and China and other non-OCC creditor nations, for their unwavering support enabling this second review under the 48-month Extended Fund Facility (EFF) arrangement. Further, our authorities are grateful for the strong financing assurances provided by the World Bank and the Asian Development Bank, whose support has been crucial in meeting Sri Lanka's financing requirements.

Unprecedented support from all stakeholders has significantly contributed to stabilizing the Sri Lankan economy, evident in its positive trajectory. Real GDP growth turned positive in Q3-2023 after a one-and-a-half-year contraction, and this momentum continued with a growth rate of 4.5 percent (y-o-y) recorded in Q4-2023. Headline inflation sharply decelerated from 70 percent in September 2022 (y-o-y) to target levels within a year and remained low at 0.9 percent in May 2024, reflecting the moderation of energy and food inflation. Reserves have improved from historically low levels and now cover about three months of imports. The exchange rate has shown notable stability, with a cumulative appreciation against the US dollar of about 20 percent during 2023 and thus far in 2024, compared to a depreciation of about 45 percent in 2022. Fiscal performance has been impressive, with larger-than-expected revenue mobilization and notable improvements in the primary balance. Despite challenges, the financial system remains resilient. Authorities remain committed to continuing the reform agenda. They are aware of risks to the outlook and stand ready to take timely and appropriate measures.

PROGRAM PERFORMANCE AND AUTHORITIES' COMMITMENT

The robust performance of the EFF arrangement has been particularly instrumental in restoring macroeconomic stability. Authorities met all quantitative targets, except one, which was missed by a small margin. All continuous structural benchmarks (SBs) were met, and the majority of other SBs were either met or implemented with delay, with measures now being taken to meet the remaining SBs. The Sri Lankan authorities remain steadfast in their commitment to leading the implementation of comprehensive fiscal and pro-growth reforms, while ensuring support for vulnerable segments of society. They are also dedicated to implementing effective monetary and financial sector policies and enhancing resilience in the external sector and governance. These efforts have led to a remarkable recovery from the largest economic contraction since independence and restored price and exchange rate stability, thereby fostering a more positive economic outlook, compared to the dire situation faced in 2022.

Sustaining this positive momentum is currently the foremost priority, necessitating long-lasting solutions to perennial issues and addressing deep-rooted structural impediments. This journey is extensive, with the next immediate milestone being the completion of the public debt restructuring process. Authorities are actively working towards finalizing agreements with all bilateral partner countries and engaged in good-faith negotiations with commercial creditors. Concurrently, bold reforms are being undertaken to ensure sustainable and inclusive growth over the medium to long term. To mitigate any risks to the program posed by upcoming elections, our authorities are dedicated to protecting the hard-earned gains and frontloading measures in government revenue mobilization and reserve accumulation. The key elements of the economic adjustment program supported by the EFF arrangement have been incorporated into the Economic Transformation Bill, which was submitted to Parliament in May 2024.

Fiscal Policy and Reforms

The fiscal reforms implemented thus far have produced outcomes that surpass initial expectations. Authorities have taken decisive measures to tackle weak government revenue, significant primary deficits, and the revival of loss-making state-owned enterprises (SOEs). Government revenue is forecasted to increase from 8.2 percent of GDP in 2022 to 15.0 percent of GDP in 2025, with a significant jump to 11.0 percent of GDP already achieved in 2023. This increase in revenue mobilization was enabled by a broad-based rise in revenue from direct and indirect taxes. The increase in revenue mobilization, has, however, not been without at the cost of significant hardships it imposed on individuals and businesses. This happened during a period when their real income was severely affected following the worst economic contraction combined with elevated price levels. This demonstrates the authorities' resolve to take bold measures aimed at long-term gains, regardless of their popularity. The adverse impact of economic adjustment measures on the poor could be mitigated to some extent by enhanced spending on social safety nets and other measures to empower economically vulnerably groups. Efforts are underway to implement a package of new tax policy measures, set to take effect from January 2025, aimed at bolstering the upward trajectory of government revenue. Further, measures towards establishing a property valuation database, operationalizing a nationwide digital Sales Price and Rents Register, and enhancing data sharing among government entities would streamline the introduction of property tax as a key component of sustaining revenue mobilization efforts. Enhancing VAT compliance and overall tax administration, digitizing revenue systems, and bolstering the governance of revenue authorities are key priorities in the near term.

Authorities remain committed to improving the primary balance through revenue measures and prioritizing expenditure, without compromising on capital expenditure that is vital for growth potential. The primary balance is expected to improve from a deficit of 3.7 percent of GDP in 2022 to 2.3 percent of GDP by 2025 and beyond, with a notable turnaround already seen in 2023, recording a surplus of 0.6 percent of GDP. The upcoming Public Financial Management (PFM) Law, submitted to Parliament in May 2024, will enhance fiscal discipline, accountability, and transparency. Authorities will develop a medium-term Public Financial Management (PFM) reform strategy and action plan, scheduled for publication by the end-2024. Reforms implemented in SOEs enterprises, particularly the adoption of cost-recovery pricing in the energy sector, have resulted in these entities recording profits in 2023. Authorities have implemented significant measures to address the legacy debt of major SOEs and are currently considering additional actions to resolve the remaining debt of these entities. Additionally, SOE borrowings will be restricted to financing commercially viable activities, and a new indicative target will be established under the program to limit the issuance of Treasury guarantees for foreign exchange borrowing.

PROTECTING THE VULNERABLE AND STRENGTHENING SOCIAL SAFETY NETS

The successive economic shocks from the COVID-19 pandemic, combined with balance of payments, debt crises, and the impact of economic adjustment measures have pushed many vulnerable households below the poverty line. In response, authorities have initiated reforms to social safety nets to improve targeting, coverage, and adequacy, while shifting away from large-scale, untargeted subsidies, such as subsidized energy prices. Authorities addressed grievances in the newly introduced Welfare Benefit Payment Scheme (*Aswesuma*) and are making retroactive cash transfers to eligible individuals, potentially surpassing the social spending floor agreed upon under the program for 2023. Additionally, steps are being taken to implement an empowerment program to provide further support to selected families, with assistance from the Asian Development Bank and the World Bank. Authorities remain committed to continually enhancing spending required for social safety nets.

DEBT RESTRUCTURING EFFORTS

The expeditious completion of the debt restructuring through a transparent process aligned with debt sustainability targets under the EFF arrangement remains a top priority for the authorities. This, along with fiscal reforms, will help restore public debt sustainability over the medium term. Authorities have successfully completed nearly all components of domestic debt restructuring, providing significant liquidity relief to the government, while minimizing the impact on the banking sector and preserving financial system stability. Authorities have successfully restored confidence in the domestic markets, resulting in a notable decline of risk premia. This accomplishment is significant, especially considering that monetary financing remains prohibited, and the government has relied on market sources for deficit financing. Our authorities are actively pursuing signed bilateral agreements with OCC member countries and with the EXIM Bank of China. At the same time, they are engaged in good-faith negotiations with private commercial creditors and China Development Bank, aiming to reach an agreement in principle at the earliest opportunity. Efforts are underway to enhance the public debt management framework to prevent the reoccurrence of debt crises. In line with this goal, the Public Debt Management Act was submitted to Parliament in April 2024, with technical assistance from the World Bank and IMF. A Public Debt Management Office will be established by end-2024, with plans for full functionality by end-2025.

MONETARY AND EXCHANGE RATE POLICIES

Authorities are dedicated to maintaining the credibility of the inflation targeting regime to anchor inflation expectations and upholding a flexible exchange rate regime. The newly enacted Central Bank of Sri Lanka Act has bolstered the independence and accountability of the Central Bank, while also prohibiting monetary financing. Authorities successfully tamed galloping inflation with decisive actions, reducing headline consumer price inflation from around 70 percent (y-o-y) in September 2022 to below the target level by August 2023. As of May 2024, headline inflation remained below the 5 percent target, standing at 0.9 percent (y-o-y). This low inflation is primarily attributed to the moderation of energy and food prices, alongside a stable exchange rate, anchored inflation expectations, and subdued overall demand conditions. Monetary policy will remain data-driven and aligned with the monetary policy consultation clause under the EFF arrangement, ensuring that any sustained price pressures are promptly addressed, and inflation expectations remain well-anchored. The Central Bank remains steadfastly committed to eliminating new monetary financing and phasing out the existing stock of net credit to the government, along the path agreed under the program or earlier if market conditions warrant. Despite the significant impact of converting Treasury Bill holdings to Treasury Bonds under the domestic debt operation, the Central Bank's net equity position remains positive, in contrast to the initially projected large negative figures.

Reserve accumulation surpassed the program target for net international reserves and helped strengthen external sector resilience. The domestic foreign exchange market witnessed improved liquidity, enabling the Central Bank to make net purchases to build reserves. In April 2024 alone, net FX intervention amounted to US$ 420 million, resulting in net FX purchases of US$ 1.6 billion from January to April 2024. Despite this notable net FX absorption, the Sri Lanka rupee appreciated over 7 percent against the US dollar thus far in 2024. Consequently, gross official reserves rose to approximately US$ 5.5 billion, sufficient to cover over three months of imports. This significant improvement in the external position reflects the moderation of the trade deficit and a faster recovery in tourism revenues and workers’ remittances. These have primarily contributed to recording a surplus in the external current account balance of 1.8 percent of GDP in 2023 when compared to the deficit of 1.9 percent in 2022. Authorities remain committed to maintaining exchange rate flexibility and further strengthening external buffers through reserve buildup. Additionally, they are dedicated to phasing out the remaining restrictions on motor vehicle imports and will develop a plan to eliminate the remaining administrative measures imposed to support balance of payments.

FINANCIAL POLICIES

Authorities remain committed to safeguarding financial system stability despite numerous challenges. They will continue to closely monitor the capital adequacy of banks using forward-looking stress tests and provide additional recapitalization funds as a last resort if shortfalls were to emerge in the future. Additionally, authorities are working towards finalizing the restructuring of foreign exchange debt owed by the Ceylon Petroleum Corporation (CPC) to state-owned banks and addressing the associated capital requirements. The amendments to the Banking Act, approved by Parliament in April 2024, will enhance the supervision and governance of state-owned banks. This, along with the Banking (Special Provisions) Act enacted in September 2023, will strengthen financial sector supervision and crisis management.

STRUCTURAL REFORMS AND REDUCING CORRUPTION VULNERABILITIES

The stabilization of macroeconomic conditions and the completion of the debt restructuring process will create opportunities for growth-enhancing reforms to unlock the economy's

potential. Authorities are committed to promoting trade liberalization and implementing a National Export Strategy, while enhancing trade integration by expediting negotiations of Free Trade Agreements and connecting with global value chains. The proposed Employment Act aims to implement labor market reforms, improve labor productivity, eliminate labor market rigidities, and narrow the gender gap in employment, thereby mitigating the impact of population aging on labor supply. Additionally, promoting the digitization of the public sector will enhance its productivity and reduce vulnerabilities to corruption. Sri Lanka remains highly vulnerable to climate shocks, including increased incidence of droughts, floods, and landslides. Such climate shocks have affected lives and livelihoods, while hampering productivity in the agriculture sector and heightening risks to food security. Addressing these challenges requires financing for climate adaptation and mitigation measures from both the private sector and multilateral lending institutions. Authorities remain committed to enhancing the business environment, improving infrastructure quality, and reducing utility costs to attract investment to key development sectors.

Authorities have implemented bold measures to promote governance and combat corruption as integral parts of promoting sustainable growth over the medium term. The Anticorruption Act, enacted in August 2023, strengthened investigative powers of the Commission to Investigate Allegations of Bribery or Corruption (CIABOC). Authorities published the Governance Diagnostic report in September 2023 and, based on its recommendations, developed and published an Action Plan in February 2024. The granting of tax incentives to strategic development projects will be streamlined, utilizing transparent and rules-based criteria. Revenue authorities will develop plans to strengthen anti-corruption measures, in line with commitments under the IMF program. Authorities have already implemented measures to eliminate any corruption vulnerabilities in public procurement. They plan to amend the National Audit Act by September 2024 to strengthen the regulatory framework overseeing and managing public assets. Authorities are in the process of strengthening AML/CFT legal framework. They have published the National AML/CFT Risk Assessment Framework Report and approved the AML/CFT National Policy (2023-2028) in 2023.

CONCLUSION

Sri Lankan authorities are dedicated to ensuring long-lasting macroeconomic stability and maintaining sustainable public debt levels, with support from creditor nations, international financial institutions, and other stakeholders. However, the room for maneuverability remains limited. They are steadfastly committed to meeting the program commitments under the EFF arrangement, recognizing these as critical for success. In this endeavor, they extend deep gratitude to the creditor community and appreciate the technical and capacity development support from the Fund and other multilateral and bilateral partners. Authorities are monitoring program performance on a weekly basis, alongside staff, which allows for timely corrective measures and contingency planning when needed. In light of their unwavering commitment to achieving satisfactory program performance, our authorities appreciate the support of Executive Directors for the completion of the second review under the EFF arrangement.