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நிதி, திட்டமிடல் அமைச்சு
MINISTRY OF FINANCE AND PLANNING

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SRI LANKA: LETTER OF INTENT

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

The economic fundamentals of Sri Lanka have been improving steadily until the third quarter of 2008. The economy of the country was directed along a national, political and economic framework based on the Government's overall vision documented in the *Mahinda Chintana*. Such policies had already begun to show satisfactory results from 2006 to the later part of 2008, including high output growth, declining inflation and public debt ratios, and a strong buildup of external official reserves. However, the intensification of the global financial crisis in September 2008 has reversed many of these favorable trends, and has had an adverse effect on market confidence. At the same time the end of the decades long conflict with the LTTE in May 2009 provides new opportunities and poses new challenges for Sri Lanka.

The attached Memorandum of Economic and Financial Policies (MEFP) presents the plans and policies of the authorities of Sri Lanka for 2009-2011. In support of the policies in the attached MEFP, the Government requests that the Executive Board of the Fund approve a Stand-By Arrangement with exceptional access in an amount of SDR 1,653.6 million (400 percent of quota).

The Government of Sri Lanka believes that the policies set forth in the attached MEFP are adequate to achieve the objectives of the program, but will take any further measures that may become appropriate for this purpose. The Government will consult with the Fund on the implementation of the policies contained in the MEFP, and in advance of revisions to these policies, in accordance with the Fund's policies on such consultation.

In keeping with its policy of transparency, the Government has authorized the publication of the attached MEFP.

Sincerely yours,

Ranjith Siyambalapitiya
Actg. Minister of Finance and Planning

Ajith Nivard Cabraal
Governor, Central Bank of Sri Lanka

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

The slowdown in the global economy, coupled with declining export prices and capital outflows, is placing Sri Lanka's recent economic and social progress under strain. The balance of payments outlook has worsened while the continued weak revenue performance is undermining fiscal deficit reduction. As a result, international reserves have declined and the fiscal deficit has exceeded budget targets. In addition, strains are appearing in the financial system. Without significant policy measures, international reserves could decline further while the public debt dynamics could become unfavorable.

The objective of our program is to cushion the impact of the global financial crisis on our economy and in particular its effects on the most vulnerable, consolidating our efforts to bring down inflation, and maintaining Sri Lanka's strong record of economic growth over the past few years. The program will be guided by the political and economic framework underpinning the Government's development plans as outlined in the Mahinda Chintana. In particular, the program—which is expected to run through 2011—envisages (i) fiscal adjustment sufficient to reduce the central Government budget deficit to 5 percent of GDP by 2011, consistent with our target under the Fiscal Responsibility Act, and also bringing the CPC and CEB to break even by 2011; (ii) continued flexibility in the exchange rate (as announced in October 2008), while building up reserves to at least 3 ½ months of imports by the end of the program period; and (iii) measures to preserve the soundness of the financial sector. The quantitative targets and structural policies underlying our program are summarized in Tables 1 and 2.

I. MACROECONOMIC OUTLOOK

1. **The economic outlook for this year is challenging.** Growth is projected to slow from 6 percent in 2008 to about 3 percent in 2009 on account of the worsening global environment and the fall in domestic demand. At the same time inflation, after reaching a high of 28 percent on a year-on-year basis in June 2008, decelerated sharply to one percent in June 2009 and is expected to remain in single digits in 2009 as a result of recent monetary policy efforts and significantly lower commodity prices. Relatively lower oil prices, a sharp decline in imports, a steady flow of remittances, and continued flexibility in the exchange rate will allow the current account deficit to recover from 9 percent of GDP in 2008 to around 1¼ percent by end-2009.

2. **The economy should begin to recover in 2010 and beyond**. Assuming a recovery in the global economic conditions and gradual normalization of economic activity in the North and the East of the country, we expect growth in 2010 to increase, while inflation is expected to remain low. Over the medium term, the macroeconomic and structural policies set out in the *Mahinda Chintana*—in particular the measures aimed at reducing the cost of living, boosting infrastructure development by attracting foreign direct investment, and increasing competitiveness and productivity—should help accelerate economic growth. While the

unusual uncertainty about global economic prospects poses a downside risk, the rebound in confidence following the end of the war could contribute to a stronger recovery than projected.

II. Fiscal Policy

3. **Effective actions will be needed to reverse the declining trend in tax revenues (in percent of GDP) and bring the fiscal deficit in line with the Fiscal Responsibility Act and Government policy**. The Government's fiscal framework targets a reduction in the overall central Government deficit to 5 percent of GDP by 2011 to maintain macroeconomic stability. Deficit reduction will be supported by a strong tax effort, which will allow for higher spending on infrastructure and the social sectors. Specifically, the Government is committed to increasing tax revenue by at least 2 percent of GDP by 2011 with measures to broaden the revenue base, significantly reduce tax exemptions, and further improve tax enforcement. These will be coupled with measures to rationalize expenditure in some areas to allow room for spending on reconstruction over the medium term.

4. **We aim to contain the overall Government deficit to 7 percent of GDP in 2009 compared with 6½ envisaged in the 2009 budget.** Without action, the budget deficit for 2009 would worsen considerably compared to the 7¾ percent outturn in 2008 because of the effects of the global crisis and the stimulus package announced in January 2009. A strong fiscal effort is necessary to achieve the program target of 7 percent of GDP in 2009 and reduce the budget's heavy reliance on domestic borrowing. As revenue measures will take time to put in place and yield results, the Government's adjustment program in 2009 will rely more on expenditure restraint, while ensuring vulnerable groups are protected. In total, revenue enhancing measures are expected to yield about ¼ percent of GDP relative to the 2008 level, while expenditure rationalization will result in savings of about ½ percent of GDP. In the event of a revenue shortfall or expenditure overruns relative to the amounts envisaged for 2009 under the program, we will take prompt action to contain other current expenditure—including on goods and services and transfers—or raise further revenue to safeguard the deficit target. However, any additional expenditure as a result of higher than expected external grants from our development partners will be accommodated within the program.

5. **We have already taken a number of measures that demonstrate our commitment to our fiscal targets.** We have introduced a nation building tax and raised excise taxes on liquor, cigarettes, and other consumer items. Moreover, we have issued directives to Government institutions to maintain strict controls on budget and to justify all cost overruns. Expenditure restraint together with declining international commodity prices will result in expenditure savings of about ½ percent of GDP. The budget will aim to preserve the allocations for capital spending and expenditure to protect the vulnerable groups in society. We have taken steps to limit the length and the scope of tax exemptions granted under the Board of Investment (BOI) Act and the Inland Revenue Act with the intention of broadening

the tax base. In particular, beginning April 2008, current tax holidays for most projects granted under the BOI Act and the Inland Revenue Act are restricted to a maximum of three years from fifteen years previously. Moreover, these tax holidays will not be extended after they expire. This process of limiting exemptions will be reviewed in line with the recommendations of the tax commission (¶8).

6. **Consistent with the Government's objective of substantially increasing tax revenue, a number of tax policy and administration measures are envisaged during the program period to further reduce the budget deficit to 5 percent in 2011.** This effort will be facilitated by the full-year effect of the new revenue measures introduced in 2009 and expenditure rationalization as announced in the 2009 budget. Further, the Government has formed a Tax Commission to review current tax policy and to make recommendations on a comprehensive approach to improve the tax system aimed at the strengthening of tax collection, improve tax auditing and enforcement, and simplifying the tax system. In its proceedings, the Commission will draw on the required tax expertise and submit an interim report by mid-October 2009. The report will contain proposals for base broadening including further rationalization of income tax holidays under the Board of Investment for consideration in preparing the 2010 budget. We also intend to phase out temporary taxes, including import surcharges, as new revenue measures yield results.

7. **Given the difficult external environment, financing of the central Government deficit during 2009 is expected to come mainly from domestic sources.** In addition, we have approached some of our development partners and are in the process of discussing significant budget support. We will continue to explore options for private market external financing to supplement donor resources. However, to keep this financing consistent with the Government's goals of ensuring the public debt sustainability, we will limit such borrowing to less than US$1,750 million during the course of the program. The CBSL will work with the Ministry of Finance to improve its management of the Government's cash flow.

8. **The Government recognizes that key state owned enterprises need to improve their performance and make a greater contribution to economic growth.** The Government's policy is to ensure that state owned commercial enterprises run efficiently and do not rely on subsidies from the Treasury. Specifically, the aim is to ensure that the Ceylon Electricity Board (CEB) and the Ceylon Petroleum Corporation (CPC) break even by end-2011. We have already taken measures toward the achievement of this objective. With respect to the CEB, we raised tariffs by 35 percent in March 2008, and passed the Sri Lanka Electricity Act in March 2009 which established an independent regulator for the sector, which should also result in management improvements in this sector. Further improvements to the cost structure of the CEB will be realized by shifting toward lower cost electricity generation. With respect to the CPC, we fully passed through increases in international oil prices by raising the domestic price of petrol. We will continue to monitor developments and take necessary measures to bring these enterprises to break even by 2011. In this regard, continuous assessments will be made of the operational cash flows of these enterprises and

required adjustments will be made including to management and operations. Any subsidies will be targeted to vulnerable groups and transparently reflected in the Government budget. The Government has established a Joint Review Mechanism through a committee consisting of high-level representatives from the Ministry of Finance, the CEB, the CPC, and the CBSL, which will make appropriate recommendations on an ongoing basis, including on cash flow management, to the Government. The committee is expected to submit their report by end-August 2009.

9. **We are also committed to developing a plan to address outstanding debts between the key state-owned enterprises.** The plan, which we intend to finalize by end-December 2009, will clearly identify all elements of circular debt including the identification and reconciliation of debts owed and due among the two largest state owned enterprises and a mechanism and timeframe for settling these debts. The Ministry of Finance will monitor and coordinate this exercise.

10. **Reconstruction of the North and East and the protection of vulnerable groups adversely affected by the conflict will be an integral part of our program.** To this end the government has moved quickly to provide humanitarian assistance to those affected by the conflict and to develop a post-war reconstruction plan. The immediate priority is addressing the humanitarian needs of the estimated 280,000 internally displaced persons (IDPs). The government aims to resettle 70-80 percent of IDPs by the end of the year. The resettlement plan involves restoring basic services including water, electricity, health services, and education, and the development of economic and social infrastructure in consultation with local officials and communities in the affected areas. Work is also underway on a broader reconstruction plan for the Northern province. A newly established Presidential Task Force is leading this effort. A consultative committee of humanitarian assistance—which includes representatives from the international community—has also been set up to advise on issues relating to humanitarian assistance and the provision of basic services to IDPs. Key elements of the reconstruction plan include restoration of law and order, conducting local government and provincial council elections—the first of which are scheduled to take place in August—and the rebuilding of essential infrastructure.

11. **Reconstruction spending needs in the years ahead will be considerable.** In 2009 the government intends to make room within the programmed deficit targets for spending on humanitarian assistance and the resettlement of IDPs using savings in existing budget provisions, redeployment of certain categories of military personnel for demining and for the provision of basic infrastructure, and any external grants from our development partners. About two percent of the projected government spending will be used for the provision of humanitarian assistance and the resettlement of displaced persons. A needs assessment is expected to be completed by end July 2009 to determine additional funds needed for the broader reconstruction strategy. Needed funds will be found both through savings in military spending beginning with the 2010 budget, and external financing in the form of concessional loans and grants from our development partners.

III. EXCHANGE RATE AND MONETARY POLICY

12. **The Central Bank of Sri Lanka (CBSL) has allowed greater flexibility in the exchange rate** to facilitate the needed adjustment to the global financial and economic crisis while rebuilding its international reserves. Consistent with this objective, the CBSL intends to allow the necessary flexibility in the exchange rate to build up international reserve coverage to at least 3 ½ months of imports by the end of the program, and will limit its intervention to smooth volatility in the foreign exchange market. The Government will continue to pursue other steps to build reserves including bilateral swaps and the sale of diaspora bonds. At the same time, the Government is committed to staying current on all its external debt obligations. Monetary policy will aim to control inflation while ensuring the adequate provision of resources to the private sector.

13. **The CBSL will continue to implement an effective monetary policy framework.** Reserve money will continue to be the nominal anchor and policy interest rates will also be adjusted as appropriate to signal the stance of monetary policy. We have already harmonized the penal rate for commercial bank borrowing from the CBSL and the reverse repo rate and removed restrictions on commercial banks' access to the repo and reverse repo facility. This has established an explicit corridor for money market interest rates and has allowed the CBSL to more effectively maintain stability in short-term interest rates.

14. **During the program period we will not intensify** any existing exchange restrictions or introduce any new restrictions or multiple currency practices. Temporary restrictions imposed by the CBSL in October and November 2008 on margin deposit requirements on importation of vehicles and selected consumer goods and on forward sales and purchases of foreign exchange were removed in March and April 2009.

IV. STRENGTHENING THE FINANCIAL SYSTEM

15. **We will put in place a comprehensive strategy to strengthen the financial sector, to build confidence, and to address recent problems.** The swift action by the CBSL with respect to Seylan Bank has restored confidence in the bank. As part of the ongoing process to deal with the Seylan Bank issue, the CBSL has directed the Bank to issue an appropriate number of voting shares to generate a capital infusion of around Rs. 3 billion by end-August. This would ensure that the bank meets the minimum capital adequacy requirement by end-December 2009. At the same time, the CBSL will continue to implement the eight point stimulus package for finance and leasing companies with the aim of avoiding spillovers to healthy financial institutions.

16. **The CBSL will continue to improve financial sector regulation.** Prudential regulations have already been strengthened by: adopting Basle II capital adequacy framework; introducing a new share ownership policy for banks; issuing a mandatory direction on corporate governance; issuing a revised direction on loan classification, provisioning and income recognition including imposing a one percent general provision on

outstanding loans; and issuing a direction on maximum amount of accommodation. To further strengthen financial sector regulation, the CBSL aims to ensure banks' compliance with all regulations including capital adequacy, exposure limits and foreign exchange net open position limits by end-2009. Also, given the expected slowdown in economic activity and potential rise in non-performing loans, the CBSL will instruct all banks to have adequate capital to cover future losses in line with international best practice in loss recognition. We have already taken steps to raise the capital requirement of finance companies, and intend to raise capital requirements in the insurance sector as part of the proposed Insurance Companies Act.

17. **The CBSL will also address gaps in the supervisory framework.** To that end, the CBSL intends to issue guidelines to improve banks' integrated risk management frameworks and reinforce the ability of the CBSL to perform consolidated supervision. To broaden the scope of financial sector supervision, greater clarity for the CBSL's legal authority in enforcing regulations on the deposit taking financial institutions will be introduced through an amendment to the Finance Company Act by end-December 2009 and Banking Act by June 2010. With respect to the Banking Act, the Monetary Board will approve a draft amendment by end-September 2009 as an interim measure. The proposed amendment to the Banking Act will also strengthen the definition of large exposures and related party lending to better capture all material risks. The CBSL intends to issue prudential regulations and guidelines to credit card companies and payment service providers during 2009.

18. **The CBSL intends to put in place a framework for the orderly workout of problem banks and finance companies to preserve financial stability.** The proposed amendment to the Banking Act and Finance Company Act will address weaknesses in the current law with regard to the liquidation and acquisition processes to strengthen viable institutions, and introduce measures to encourage the unwinding of unviable ones. We also aim to make the Finance Company Act and the Banking Act compatible with the new Companies Act. Finally, the CBSL will further improve its contingency plan for addressing any future financial sector instability and further strengthen its intervention procedures. The improved plan will also develop an approach to dealing with potential stresses in banks and finance companies.

V. Other Policies

19. **A safeguards assessment, which found that the CBSL has developed its safeguards in many respects and has a relatively strong safeguards framework, was concluded in May.** We welcome the findings and conclusions of the safeguards report and the CBSL will work with the IMF staff in the coming months to implement the recommendations outlined in the safeguards assessment report with a focus on the priority recommendations in the areas of external audit and data reporting.

VI. RISKS AND CONTINGENCIES

20. **The current global economic environment is uncertain, bringing economic and financial risks to the program.** Key risks include a sharper-than-anticipated economic slowdown in trading partner countries which would slow export growth further, a fall in remittances inflows, and capital outflows. If these risks materialize, the Government stands ready to adjust its policies, in close consultation with IMF staff, to ensure the achievement of a sustainable external position by the end of the program period. Finally, in the event of a potentially disruptive movement in the nominal exchange rate against the U.S. dollar in either direction, the authorities will consult with Fund staff on the appropriate policy response.

VII. PROGRAM MONITORING

21. **The program will be subject to quarterly reviews with quarterly performance criteria as set out in the technical memorandum of understanding (TMU).** Completion of the first two reviews scheduled for September 2009 and November 2009 will require observance of the quantitative performance criteria for end-July 2009 and end-September 2009, respectively, as specified in Table 1. The first two reviews will also assess progress towards observance of the structural benchmarks specified in Table 2.

22. **The Government authorizes the IMF to publish this Letter of Intent and its attachments, Tables 1, 2 and 3.**

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

	12/31/2008 Actual	7/31/2009 PC	9/30/2009 PC	12/31/2009 IT	3/31/2010 IT
Quantitative performance criteria					
Net international Reserves (NIR) of the Central Bank of Sri Lanka (CBSL) (floor, cumulative change from the beginning of the year, in million US$) 1/ 2/ 3/	-1,385	-109	-13	-7	85
Reserve money of the CBSL (ceiling, eop stock, in million rupees)	268,425	274,130	280,370	300,525	310,886
Net domestic financing (NDF) of the central government from the banking system and the non-bank sector (ceiling, cumulative from the beginning of the year, in million rupees) 4/ 5/ 6/	314,289	282,004	305,001	331,817	82,234
Continous performance criteria					
Contracting and guaranteeing of medium and long-term non-concessional external debt by the government (ceiling, cumulative from end-April 2009, in million US$)	…	1,750	1,750	1,750	1,750
Accumulation of new external payment arrears (ceiling, eop, in million US$)	0	0	0	0	0
Indicative targets					
Overall balance of the Ceylon Petroleum Corporation and the Ceylon Electricity Board (floor, cumulative from the beginning of the year, in million rupees)	-49,847	…	…	-35,387	…
Memorandum items:					
External loans assumed under the program (cumulative from the beginning of the year, in million rupees) 4/	80,415	55,928	75,238	109,392	49,896
External grants assumed under the program (cumulative from the beginning of the year, in million rupees) 5/	31,222	5,644	7,825	9,631	3,326
External debt service assumed under the program (cumulative from the beginning of the year, in million rupees) 6/	109,268	72,994	89,735	136,841	42,146
Privatization proceeds to the central government in connection with the sale of central government assets 7/	0	0	0	0	0
Foreign program financing assumed under the program (cumulative from the beginning of the year, in million US$) 1/	23	0	20	40	0
Cumulative net change in the amount of foreign holdings of Treasury Bills and Treasury Bonds assumed under the program (cumulative from the beginning of the year, in million US$) 1/	-213	15	15	15	0
Official external debt service assumed under the program (cumulative from the beginning of the year, in million US$) 2/	802	446	588	837	200
Repayment of foreign currrency loan from the CBSL by the Bank of Ceylon and the People's Bank (cumulative from the beginning of the year, in million US$) 3/	40	261	283	283	0

1/ If the amount of program financing and the cumulative net change in the amount of foreign holdings of Treasury Bills or Treasury Bonds is higher/lower in U.S. dollar terms than assumed under the program, the floor on NIR will be adjusted upward/downward by the cumulative differences on the test date.

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

3/ The floor on NIR will be adjusted upwards by any repayments for the foreign currency loan from the CBSL by the Bank of Ceylon and the People's Bank in excess of the repayment schedule.

4/ If the amount of external loans is higher/lower in rupee terms than assumed under the program, the cumulative ceiling on net domestic financing of the central government will be adjusted downward/upward by the cumulative difference in external loans on the test date.

5/ If the amount of external grants is lower in rupee terms than assumed under the program, the cumulative ceiling on net domestic financing of the central government will be adjusted upward by the cumulative difference in external grants on the test date.

6/ If the amount of external debt service by the central government in rupee terms is higher/lower than assumed under the program, the ceiling on net domestic financing of the central government will be adjusted upward/downward by the cumulative difference in external debt service payments measured in rupees.

7/ If the amount of privatization proceeds to the central government in connection with the sale of central government assets is higher/lower than assumed under the program, the cumulative ceiling on NDF of the central government will be adjusted downward/upward by the cumulative receipt/reimbursement of any privatization proceeds.

Table 2. Sri Lanka: Structural Benchmarks (SB)

Actions	Type	Date
Recapitalization of Seylan Bank through a public share issuance.	SB	9/30/2009
A contingency plan for orderly workouts of problem banks and financial institutions will be developed by the CBSL.	SB	9/30/2009
Approval by the Monetary Board of a revised Banking Act and other pertinent laws and legislations that: (i) improve the bank resolution framework that more clearly defines the provisions for acquisition, and roles of the conservator and liquidator; and (ii) strengthens the definition of large exposures and related parties to better capture all material risks.	SB	9/30/2009
Submission by the tax review commission of an interim report, including on base broadening measures to be incorporated into the 2010 budget.	SB	10/15/2009
Develop a plan to address outstanding debts between the CEB, CPC and state-owned banks.	SB	12/31/2009
Submission to the parliament of a revised Finance Company Act which includes clarifying the legal authority of the CBSL in enforcing its regulations on all deposit taking finance companies.	SB	12/31/2009
Issuance of prudential regulations and guidelines to credit card companies and payment service providers.	SB	12/31/2009
Submission to parliament of the 2010 budget consistent with program targets.	SB	12/31/2009

Table 3. Actions Already Taken by the Government

Removal of all import margin requirements.
Amendments to the Nation Building Tax to raise the rate from 1 to 3 per cent.
Amendments to the excise taxes on liquor, cigarette and other items.
Finalization of the terms of reference of a tax commission to review tax policy.
Harmonization of the penal rate for commercial bank borrowing from the CBSL with the reverse repo rate.
Announcement of a recapitalization plan for Seylan Bank.