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Sri Lanka: Letter of Intent, and Technical Memorandum of
Understanding

July 05, 2012

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SRI LANKA: LETTER OF INTENT

July 05, 2012

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Ms. Lagarde:

This letter supplements the Memorandum of Economic and Financial Policies of July 16, 2009, and the Letters of Intent dated October 30, 2009; June 19, 2010; September 14, 2010; January 17, 2011; March 15, 2011; and March 15, 2012.

1. Since the end of the conflict in 2009, the Sri Lankan economy has recorded undeniable success, supported by an IMF Stand-By Arrangement (SBA). Growth averaged over 8 percent in 2010 and 2011, inflation was brought down to the single digits and kept there for the longest period in our modern economic history, the fiscal deficit was steadily reduced, helping the debt-GDP ratio to decline, and international reserves at the central bank were built up dramatically.
2. But as the economy grew, so too did imports, fueled by rapid credit growth and rising oil prices, and despite the strong performance of exports and remittances, the current account deficit widened sharply last year, putting pressure on our reserves. While continuing our efforts to mobilize foreign capital inflows to finance this deficit, in February we also adopted a bold package of measures to contain the deficit and thus reduce the financing need. These measures included: (i) the pursuance of greater exchange rate flexibility, as we scaled back foreign-exchange intervention; (ii) a tightening of monetary policy through rate hikes and the pursuance of strategies to moderate bank credit growth; (iii) a further consolidation of fiscal policy via an increase in duties and an adjustment in energy prices to reflect international developments, which also helped to address state enterprise losses; and (iv) a general commitment to use all of these policy levers flexibly, as required by changing economic circumstances.

3. Though only a few months old, the policy package has already delivered clear results. Credit growth has slowed, import growth has turned negative, and the current account deficit has narrowed. At the same time, banks have raised substantial amounts of capital abroad, there appear to be strong prospects for issuing another sovereign Eurobond in the near future, and substantial foreign inflows into the stock market have materialized. The overall balance of payments should thus register a surplus in 2012, helping us increase reserves levels once again. Further, the policy measures taken have strengthened our economic fundamentals, improved our ability to absorb shocks, and laid the basis for continued strong performance in years to come. Inflation may increase and growth slow in the near term, however, the policy measures undertaken should ease inflationary pressures going forward, and help us to cope with the global risks and their possible impact on our economy. In this context, we will maintain exchange-rate flexibility as this provides a key buffer to external shocks.

4. Though easing growth and imports have dampened budget revenue collection, we remain committed to achieving our 2012 budget deficit target of 6.2 percent of GDP through expenditure control and some revenue measures. More fundamentally, we recognize the need to strengthen revenue administration, particularly with respect to the VAT, and public financial management processes.

5. Coming to the program targets, the end-June performance criterion on net international reserves was observed, despite highly unfavorable valuation changes on the central bank's portfolio of foreign assets and accelerated repayment of oil imports credit lines. Latest data suggest the reserve money target will also have been met. Slower growth and higher interest rates have put pressure on fiscal performance, but available data indicate we nonetheless will have met the end-June benchmark on net domestic financing of the budget deficit. Cabinet approval of amendments to the Petroleum Act (structural benchmark) was received in April. Given this strong performance against program targets and our continued commitment to flexible macroeconomic policy management, we request completion of the eighth and final review of the SBA.

6. We are very pleased to bring this program to a successful conclusion. The SBA has helped us to strengthen our economy and to communicate those strengths to the outside world, and we look forward to continued, close engagement with the IMF. The precise modalities have yet to be worked out, but we intend to discuss with IMF staff the possibility of financial support for our economic development agenda under an Extended Fund Facility. This would continue to prioritize macroeconomic and financial stability and growth through prudent monetary and fiscal policies, while also addressing pressing concerns such as state enterprise performance, revenue administration, and public financial management.

7. We believe that the policies set forth in this and previous Letters of Intent are adequate to achieve the objectives of our economic program, and we stand ready to take additional measures as appropriate to ensure achievement of the objectives. We will continue to liaise with the IMF when modifying measures contained in this letter, or adopting measures that would deviate from program goals, and provide the IMF with the information necessary for program monitoring.

8. In keeping with its policy of transparency, the Government has authorized the publication of this letter and the attached Technical Memorandum of Understanding.

Yours sincerely,

/s/

Gitanjana Gunawardena
Deputy Minister of Finance and Planning

/s/

Ajith Nivard Cabraal
Governor, Central Bank of Sri Lanka

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

	2009	2010	2011	2012					
				End-Mar. Indicative Targets			End-Jun. Performance Criteria on NIR and Indicative Targets on Reserve Money and NDF		
				7th Review	Adj.	Prel.	8th Review	Adj.	Prel.
Quantitative performance criteria and indicative targets									
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/ 4/ 5/	2,725	921	-1,061	-684	-415	-251	-670	-574	-324
Reserve money of the CBSL (ceiling, eop stock, in million rupees)	303,500	358,869	442,436	468,500		485,802	474,165		462,319
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) 6/ 7/ 8/ 9/ 10/	392,476	242,259	259,245	230,814		248,992	300,478		296,167
Continuous performance criteria									
Accumulation of new external payment arrears (ceiling, eop, in million US\$)	0	0	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) 11/	-19,400	-22,900	-113,800						
Memorandum items:									
External debt service assumed under the program (cumulative from the beginning of the year, in million rupees) 7/	141,914	108,607	132,411						
Privatization proceeds to the central government in connection with the sale of central government assets (in million rupees) 8/	0	0	0						
Outstanding claims by the Bank of Ceylon on the central government (item VIII (e, 1) on the balance sheet of the Bank of Ceylon, in million rupees) 9/	6,038	1,575	1,575						
Foreign program financing assumed under the program (cumulative from the beginning of the year, in million US\$)	0	40	...	...		...	...		...
External commercial loans (including Eurobonds and syndicated loans) assumed under the program (cumulative from the beginning of the year, in million US\$) 2/	500	1,000	1,000	0		0	0		0
Cumulative net inflows into the Treasury Bill and Treasury Bond market assumed under the program (cumulative from the beginning of the year, in million US\$) 1/	1,345	467	232	...		...	...		...
Official external debt service assumed under the program (cumulative from the beginning of the year, in million US\$) 3/	878	874	1,072	...		...	...		...
Settlement of syndicated loans assumed under the program (cumulative from the beginning of the year, in million US\$) 4/	225	25	0	0		0	0		0
Outstanding value (i.e., receivables) on swaps and forwards by CBSL (eop stock, in million US\$) 5/	245	97	0	782		1,052	782		878

1/ If the cumulative net inflows into the Treasury Bill market and Treasury Bond market 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 (discontinued after Dec 2011).

2/ If the amount of commercial borrowing (including Eurobonds and syndicated loans) 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 difference on the test date.

3/ 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 (discontinued after Dec 2011).

4/ If the amount of debt service on syndicated loans 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. The adjustor is introduced from end-December 2009.

5/ If the outstanding value on swaps and forwards is higher/lower than assumed under the program, the floor on NIR will be adjusted upward/downward by the difference on the test date. This adjustor is introduced from end-March 2012. The outstanding value as of February 29, 2012 was \$782 million. The downward adjustment in the NIR target will be up to a maximum of \$ 600 million.

6/ 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. From end-December, external loans will be defined as external program loans and external commercial loans (including Eurobonds and syndicated loans).

7/ 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.

8/ 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.

9/ If the amount of outstanding claims by the Bank of Ceylon on the central government (item VIII (e, 1) on the balance sheet of the Bank of Ceylon) is lower in rupee terms than assumed under the program, the NDF of the central government will be adjusted upward by the difference on the test date.

10/ The 2012 indicative targets on NDF include restructuring bonds amounting to Rs. 60,000 million issued to settle outstanding dues from state owned institutions to the Ceylon Petroleum Corporation.

11/ Slight revisions to end-December 2010 and end-December 2011 data are based on unaudited results.

Table 2. Sri Lanka: Structural Benchmarks (SB)

Structural Benchmarks	Date	Status
Recapitalization of Seylan Bank through a public share issuance.	9/30/2009	Implemented
A contingency plan for orderly workouts of problem banks and financial institutions will be developed by the CBSL.	9/30/2009	Implemented
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.	9/30/2009	Implemented
Submission by the tax review commission of an interim report, including on base broadening measures to be incorporated into the 2010 budget.	10/15/2009	Implemented with delays
Approval by Parliament of an interim budget for the first four months of 2010 consistent with program targets.	12/15/2009	Implemented
Develop a plan to address outstanding debts between the CEB, CPC and state-owned banks.	12/31/2009	Implemented
Issuance of prudential regulations and guidelines to credit card companies and payment service providers.	12/31/2009	Implemented
Submission to parliament of the 2010 budget consistent with program targets.	4/30/2010	Implemented with delays
Submission to the parliament of a revised Finance Business Act which includes clarifying the legal authority of the CBSL in enforcing its regulations on all deposit taking finance companies.	5/31/2010	Implemented with delays
Submission by the Presidential Tax Commission of a final report, including specific tax reform measures.	8/31/2010	Implemented with delays
Parliamentary approval of full-year 2010 budget consistent with program targets.	8/31/2010	Implemented
Issuance of regulations to establish a deposit insurance scheme.	9/30/2010	Implemented
Submission to parliament of the 2011 budget consistent with program targets, including income tax and VAT reform measures.	11/30/2010	Implemented
Cabinet approval of a regulatory framework for private-sector superannuation funds.	12/31/2010	Not met
Restructure the overdue obligations accumulated up to end-2009 by Ceylon Electricity Board to Ceylon Petroleum Corporation.	12/31/2010	Implemented with delays
Amend BOI regulations.	3/31/2011	Implemented
Amend the Strategic Investment Law and issue supporting regulations on defining and contracting strategic projects.	3/31/2011	Implemented
Cabinet approval of amendments to the Banking Act.	3/31/2011	Implemented with delays
Cabinet approval of amendments to the Petroleum Act.	9/30/2011	Implemented with delays
Submission to parliament of the 2012 budget.	11/30/2011	Implemented

TECHNICAL MEMORANDUM OF UNDERSTANDING

1. **This Technical Memorandum of Understanding sets out a framework for monitoring the performance of Sri Lanka under the program supported by the Stand-By Arrangement (SBA).** It specifies the performance criteria and indicative targets (including adjustors) under which Sri Lanka's performance will be assessed for the eighth and final review contemplated for completion by July 20, 2012.

I. FISCAL TARGETS

A. Indicative Target on Net Domestic Financing of the Central Government

2. **Net domestic financing (NDF) is defined as the change in net credit to the central government by the domestic banking system and the net change in holdings of treasury bills and other government securities by the domestic non-bank sector.** For the purpose of program monitoring, the central government is defined to include line ministries, departments, and other public institutions. The Central Bank of Sri Lanka (CBSL), state-owned enterprise, parastatals and other agencies that do not receive subventions from the central government are excluded from the definition of central government. NDF of the central government is defined as the sum of (i) net borrowing from the CBSL (ways and means advances, loans, holdings of treasury bills, treasury bonds, and other central government bonds minus deposits); (ii) net borrowing from domestic commercial banks and the domestic non-bank sector (loans, advances, holdings of restructuring bonds, and holdings of treasury bills and other central government securities minus deposits); and foreign holdings of Treasury Bills and Treasury Bonds. In 2009, NDF of the central government defined in this manner amounted to Rs. 392.5 billion. Of this amount, Rs. 49.0 billion was net borrowing from the domestic banking system, Rs. 185.2 billion was net borrowing from the domestic non-bank sector, Rs. 146.9 billion was net foreign inflows into the Treasury Bill and Treasury Bond markets and Rs. 11.3 billion was net borrowing from other sources.

B. Indicative Target on the Sum of the Overall Balance of the Ceylon Electricity Board and the Ceylon Petroleum Corporation

3. The balance of the overall profit or loss position of the Ceylon Electricity Board (CEB) and the Ceylon Petroleum Corporation (CPC) from their operating income statements is measured from above the line on an accrual basis. At end-December 2009, the sum of that overall position of the CEB and CPC defined in this manner stood at Rs. -19.4 billion.

II. MONETARY TARGETS

A. Indicative Target on Reserve Money of the CBSL

4. **Reserve money of the CBSL** consists of currency in circulation (with banks and with the rest of the public), financial institutions' domestic currency deposits at the CBSL, and the deposits of following government agencies: the National Defense Fund (General Ledger Acc. No. 4278), the Buddha Sasana Fund A/C (General Ledger Acc. No. 4279); and the Road Maintenance Trust Fund (General Ledger Acc. No. 4281). At end-December 2009, reserve money defined in this manner stood at Rs. 303.5 billion. For the purpose of program monitoring, reserve money on the test date shall be measured as average reserve money during the prevailing reserve week (Friday to Thursday).

III. EXTERNAL SECTOR TARGETS

A. Performance Criterion on Net Official International Reserves

5. **Net official international reserves (NIR) is defined as (i) the difference between the gross foreign assets and liabilities of the CBSL and (ii) the balance of State Treasury's (DSTs) Special Dollar and Yen 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. Excluded from gross foreign assets will be participation in international financial institutions; holdings of nonconvertible currencies; 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); 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; the use of Fund credit; Asian Clearing Union debit balance and commitments to sell foreign exchange arising from derivatives such as futures, forwards, swaps, and options. In addition, NIR will include the balance of the DSTs' Special Dollar and Yen Revolving accounts. DST accounts are foreign currency accounts held by the Treasury and managed by the CBSL as an agent of the government. At end-December 2009, NIR defined in this manner stood at U.S. dollars 4,150 million.

The following adjustment will apply:

6. If the amount of commercial borrowing (including Eurobonds and syndicated loans)—as set out in Table 4—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 difference on the test date.

7. An adjustor to the NIR target of the CBSL will be implemented to reflect changes in the CBSL's net position under foreign exchange forwards and swaps. Specifically, if the outstanding value on forwards and swaps is higher/lower than assumed under the program (Table 4), the NIR target of the CBSL will be adjusted upward/downward by the change in the outstanding value of forwards and swaps relative to the programmed level. The CBSL's outstanding value on swaps and forwards was \$782 million at February 29, 2012. The downward adjustment in the NIR target will be up to a maximum of \$600 million.

8. The floor on NIR will be adjusted upward for any increase in Sri Lanka's allocation of Special Drawing Rights (SDR) from the IMF. Sri Lanka's SDR allocation at the time of approval of this arrangement amounted to SDR 70.868 million.

B. Performance Criterion on External Payment Arrears

9. **A continuous performance criterion applies to the nonaccumulation of external payments arrears on external debt contracted or guaranteed by the central government (as defined in ¶2) or the CBSL.** External payments arrears consist of external debt-service obligations (principal and interest) on debt as defined in ¶9 that have not been paid at the time they are due, as specified in the contractual agreements. 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.

IV. DATA REPORTING REQUIREMENTS

10. 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. All the program monitoring data will be provided by the Ministry of Finance and the Central Bank of Sri Lanka (CBSL). Data relating to the external and monetary targets will be furnished within no more than three weeks after the end of each month.¹ With regards to the fiscal targets, the data in table 5 will be furnished within no more than five weeks after the end of each month and the data in table 6 within no more than nine weeks after the end of each month. For the overall balance of the CEB and the CPC, estimates will be available within four weeks.

¹ The deadline for submitting monetary and external data for end-December 2010 and 2011 will be five weeks due to the added time needed to close the books at the end of the year.

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11. For the purpose of monitoring the fiscal performance under the program, data will be provided in the format as shown in Tables 5 and 6.

12. For the purpose of monitoring the monetary targets under the program, data will be provided in the format shown in Table 7.

13. For the purpose of monitoring the external sector performance under the program, data will be provided in the format shown in Tables 8 and 9.

Table 1. Sri Lanka: External Financing Assumptions
(cumulative from the beginning of the year, in millions of rupees)

	2010	2011		2012		
	Dec	Mar	Jun	Dec	Mar	Jun
External Program Loans	5,699	...	...	...	...	...
External Commercial Loans	0	0	0	0	...	...
External Debt Service	96,555	31,221	57,915	116,466	...	...

Table 2. Sri Lanka: Assumptions on Privatization Proceeds
(cumulative from the beginning of the year, in millions of rupees)

	2010	2011		2012		
	Dec	Mar	Jun	Dec	Mar	Jun
Privatization Proceeds	0	0	0	0	...	...

Table 3. Sri Lanka: Outstanding Claims by the Bank of Ceylon on the Central Government
(item VIII (e, 1) on the balance sheet of the Bank of Ceylon, in millions of rupees)

	2010	2011		2012		
	Dec	Mar	Jun	Dec	Mar	Jun
Foreign Bills Inward	6,038	1,575	1,575	1,575	...	...

Table 4. Sri Lanka: External Financing for NIR Purposes

(cumulative from the beginning of the year unless otherwise stated, in millions of U.S. dollars)

	2010	2011		2012		
	Dec	Mar	Jun	Dec	Mar	Jun
Program Loans	50	...	...	...	...	...
External Commercial Loans	0	0	0	0	0	0
Treasury Bills/Bonds	0	0	0	0	...	...
Official External debt service	824	250	531	1,070	...	...
Settlement of Syndicated Loans	25	0	0	0	...	...
Outstanding value on swaps and forwards by CBSL 1/	200	0	0	0	782	782

1/ End of period stock.

Table 5. Sri Lanka: Summary of Central Government Operations 1/	
(In millions of rupees)	
Total revenue	
Tax revenue	
	Income taxes
	Value added tax
	Domestic
	Imports
	Excise taxes
	Tax on liquor
	Tax on cigarettes/tobacco
	Petroleum
	Motor vehicle
	Other
	Stamp duties
	Port and airport development duty
	Debit tax
	Import duties
	Cess levy
	Special commodity levy
	Nation Building Tax
	Telephone subscriber levy
	Licence taxes and other
Nontax revenue	
Grants	
Total expenditure and net lending	
	<i>of which:</i> Interest payments
	Foreign
	Commercial
	Domestic
Overall balance of central Government	
Financing	
	Net domestic financing
	Net external financing
	<i>of which:</i> Program loans
	<i>of which:</i> Project loans
	<i>of which:</i> Commercial borrowing
	<i>of which:</i> Amortization
	Privatization

1/ As agreed for the purpose of monitoring the program

Table 6. Sri Lanka: Central Government Expenditure 1/
(In millions of rupees)
Total expenditure and net lending
Current expenditure
Civil service wages and salaries
Other civilian goods and services
Security related expenditure
Subsidies and transfers
Households
Of which : Samurdhi
Pensions
Fertilizer
Institutions, corporations, other government agencies
Interest payments
Foreign
Commercial
Domestic
Capital expenditure and net lending

1/ As agreed for the purpose of monitoring the program

Table 7. Sri Lanka: Balance Sheet of the Central Bank 1/
(In millions of rupees)
Net foreign assets
Foreign assets
Cash and balances abroad
Foreign securities
Claims on ACU
SDRs
IMF related assets
Receivables
Foreign currency reserve
Foreign liabilities
IMF and nonresident account
Liabilities to ACU
Net domestic assets
Claims on government
Advances
Treasury bills and bonds
Cash items in collection
Government deposits
Claims on commercial banks
Medium and long term
Short term
Other items net
Reserve money
Currency in circulation
Commercial bank deposits
Government agencies deposits

1/ As agreed for the purpose of monitoring the program

Table 8. Sri Lanka: Summary of Central Bank Foreign Exchange Operations 1/

(In millions of USD)

1. Total inflows

Loans
 Program
 IMF
 Project (cash component only)
 Interest earnings, forex trading profits, cap gains
 Purchases of foreign exchange
 Change in balances in DST's A/Cs
 Other inflows
 Borrowing from SLDBs
 Loans from FCBUs
 Syndicated Loans
 Commercial loans
 Repayments of BOC and PB claims

2. Total outflows

Public Debt Service Payments
 Amortization
 Principal (foreign loans)
 Settlement SLDBs
 Settlement FCBU
 Settlement of syndicated loans
 Interest
 Foreign loans
 Domestic foreign currency loans
 Payments to the IMF/ change in valuation of liabilities
 Foreign exchange sales to commercial banks
 Foreign exchange deposits at BOC and PB

3. Net flow at current rates (1-2)**Net International Reserves****Gross International Reserves****Cumulative net inflows into the Treasury Bill/Bond market**

1/ As agreed for the purpose of monitoring the program

Table 9. Sri Lanka: Estimated Gross Official Reserve Position (in US\$ million) 1/

Date	Central Bank		Reserve Position at I.M.F. & SDR hol. 3	Total {2}+{3} 4	Government			Total Gross Official Reserves		Liabilities					Net International Reserves	Overall balance	
	Reserves managed by IOD				Crown Agent's Credit Balance 5	D S T's Special Dollar Revolving Cr.balance 6	DST's Yen Accounts 7	Total (5)+(6) +(7) 8	(without ACU) {1}+{3}+{8} 9	(with ACU) (4)+(8) 10	Other Deposits	Asian Clearing Union	Drawings from the IMF	Currency Swap			Total
	(without ACU) 1	(with ACU) 2															

1/ As agreed for the purpose of monitoring the program