IMF Staff Concludes the 2018 Article IV Mission with Sri Lanka and Discusses Progress of Economic Reform Program

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A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

An IMF staff team led by Manuela Goretti visited Colombo from February 27 – March 9 to hold discussions for the 2018 Article IV consultation and advance the technical work on the fourth review of Sri Lankan authorities' economic reform program under the three-year Extended Fund Facility (EFF).

The IMF mission had constructive discussions with the Sri Lankan authorities on the 2018 Article IV Consultation and made progress towards a staff-level agreement on the fourth review of the EFF-supported program. Program discussions will continue in April in Washington D.C. during the Spring Meetings of the IMF and the World Bank.

Economic Recovery Set to Continue

Following a series of weather-related shocks in 2017, the economy is gradually normalizing. Real GDP growth is projected to rise to 4.4 percent in 2018, supported by a recovery in agriculture and industry and robust growth in services, reaching 5 percent over the medium term. Inflation is projected to revert to around 5 percent by end-2018, as food prices stabilize.

Reforms have progressed under the program but vulnerabilities remain

Despite weather-related shocks and some delays in implementation, program performance remains broadly on track. The new Inland Revenue Act (IRA) and the CBSL's Roadmap towards inflation targeting represent landmark reforms and their successful implementation is critical going forward. Fiscal consolidation is advancing, with preliminary data showing a primary surplus in 2017. The CBSL has been effective in curbing credit growth and stabilizing inflation despite recent pressures, while stepping up its pace of reserve accumulation.

Nevertheless, the economy remains vulnerable to adverse shocks given the still sizable public debt and low external buffers. Looking ahead, to secure these hard-won gains and support inclusive, sustained growth, the reform momentum needs to continue and policy frameworks and institutions further strengthened.

Strengthening institutions to promote stability and inclusive growth

Against this backdrop, the authorities should push ahead with their *Vision 2025* strategy to support Sri Lanka's rapid and inclusive growth through ambitious structural, macro-economic, and social reforms. Key priorities include: (i) advancing fiscal consolidation through revenue mobilization, a more robust fiscal rule, and stronger SOE governance, (ii) modernizing monetary, financial and exchange rate policy frameworks, and (iii) accelerating growth-enhancing structural reforms.

i. Advancing fiscal consolidation through stronger fiscal rules and SOE governance

Progress in revenue-based fiscal consolidation has helped preserve space for public investment and social spending while bringing down public debt. Further revenue mobilization is needed to meet the 2018 primary surplus target and reduce the overall deficit to 3.5 percent of GDP by 2020. The new IRA represents a major achievement towards a simpler and more equitable tax system, and its smooth implementation will be critical. There is also scope to further strengthen efficiency of public investment and social safety nets.

Beyond 2020, a well-designed fiscal rule can help build on this progress and place debt firmly on a downward path. In line with international best practices, the Fiscal Management Responsibility Act should be amended to contain mechanisms to ensure compliance, supported by improvements in debt management and greater fiscal transparency.

Energy pricing reforms are a priority to contain fiscal risks from State Owned Enterprises (SOEs). Targeted social transfer programs can help to mitigate the distributional impact of these reforms. Timely publication of the audited financial statements of major SOEs and regular review of performance under the recently introduced Statements of Corporate Intent would also strengthen SOEs governance and transparency.

ii. Modernizing monetary, financial, and exchange rate policy frameworks

The CBSL has prudently managed monetary policy in the face of price shocks and market volatility. The CBSL should remain focused on price stability as its primary objective and stand ready to tighten if signs of demand-side inflation pressures or accelerating credit growth appear. The favorable external environment offers a window of opportunity to bolster reserve buffers and, in the event of volatile global capital flows, exchange rate flexibility should be the first line of defense. Planned changes to the Monetary Law Act, as part of the Roadmap towards flexible inflation targeting, are a key milestone to further strengthen the CBSL's mandate, governance, and autonomy.

The authorities should remain vigilant against a buildup of systemic risks in the financial sector. If needed, further macroprudential tools can be considered to curb excessive credit growth in certain sectors. The banking sector is on track to meet the Basel III requirements and should prepare contingency plans to insure against an adverse shock. Non-bank financial institutions should be subject to the same level of oversight as banks, with problem institutions promptly resolved.

iii. Accelerating structural reforms to promote inclusive growth

The reforms under the authorities' *Vision 2025* are important in promoting rapid and inclusive growth. Sri Lanka's protectionist trade regime should be gradually liberalized through reform of tariffs, para-tariffs, and non-tariff barriers, as well as closer regional integration. Robust implementation of the new IRA and the one-stop shop for FDI will improve the investment climate. Efforts to combat corruption should be stepped up, including through greater transparency in fiscal and SOE management and a stronger AML/CFT regime.

Addressing Sri Lanka's sizable gender gap and boosting female labor force participation will require labor market reforms and effective gender budgeting, including through vocational training, flexible work arrangements, safe transportation, and child care support. A well-designed natural disaster risk financing framework will help Sri Lanka address costs associated with climate change.

The mission met with Prime Minister Wickremesinghe, State Minister of Finance Wickramaratne, State Minister of National Policies and Economic Affairs De Silva, Governor of the Central Bank of Sri Lanka Coomaraswamy, other public officials, and representatives of the business community, civil society and international partners.