

BUFF/16/83

November 18, 2016

**The Acting Chair's Summing Up
Sri Lanka—First Review Under the Extended Arrangement
Under the Extended Fund Facility and Request for
Modification of Performance Criterion
Executive Board Meeting 16/104
November 18, 2016**

Executive Directors commended the Sri Lankan authorities for implementing prudent macroeconomic policies and keeping the Fund-supported program broadly on track under difficult circumstances. They welcomed initial signs of stabilization in the economy and financial markets. Despite the overall strong performance, Directors noted uneven progress in structural reforms and implementation challenges. They called for intensified efforts and strong political commitment to advance fiscal and structural reforms, aimed at improving policy buffers, economic resilience, competitiveness, and the investment climate.

Directors considered that the 2017 budget proposal is broadly in line with the fiscal consolidation objectives. They welcomed the authorities' intention to adjust expenditures in the event of revenue shortfalls. Directors stressed the importance of underpinning fiscal consolidation with high-quality tax policies, and implementing the new Inland Revenue Act and the amendments to the value added tax in a timely manner. Complementary reforms to strengthen tax administration and public financial management are also crucial for fiscal consolidation.

Directors emphasized the need to manage fiscal risks associated with state-owned enterprises (SOEs). They encouraged the authorities to complete a resolution strategy for Sri Lankan Airlines, and to establish an automatic pricing formula for fuel and electricity in order to place the state energy enterprises on a sounder financial footing. Broader reforms to improve SOE governance and oversight would help limit contingent liabilities.

Directors concurred that the current monetary policy stance is appropriately tight. They welcomed the authorities' readiness to raise policy rates further if inflationary pressures re-emerge or credit growth accelerates, complemented with macro-prudential tools to rein in credit growth, if necessary. Directors encouraged steps to enhance the effectiveness of monetary policy transmission and central bank autonomy.

Directors recommended that the shift to a more flexible exchange rate regime take place in tandem with the transition towards a flexible inflation targeting framework, based on a carefully-designed roadmap. Given Sri Lanka's large external debt and vulnerability to

shocks, they saw a need to continue accumulating international reserves through direct purchases.

Directors highlighted the importance of further strengthening the supervisory and regulatory framework for the financial sector. They welcomed the recent approval of a resolution mechanism for repayment to depositors of insolvent finance companies. Directors encouraged the authorities to monitor the impact of ongoing SOE reforms on the financial soundness of state-owned banks.