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June 29, 1984

To: Members of the Executive Board

From: The Acting Secretary

Subject: Sri Lanka - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Sri Lanka, which has been tentatively scheduled for discussion on Wednesday, August 8, 1984. A draft decision appears on page 27.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Szapary (ext. (5)7365).

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INTERNATIONAL MONETARY FUND

SRI LANKA

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the 1984 Consultation with Sri Lanka

Approved by P.R. Narvekar and Manuel Guitian

June 28, 1984

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I. Introduction

The 1984 Article IV consultation discussions with Sri Lanka were held in Colombo during May 9-21, 1984. Discussions were held with Mr. De Mel, Minister of Finance and Planning; Dr. Rasaputra, Governor of the Central Bank; Dr. Tilakaratna, Permanent Secretary of Finance and Planning; and other senior officials. The staff team consisted of Messrs. Szapary (Head, ASD); Golle (ASD); Cardemil (ETR); Rado (FAD); Mendras (EP, ASD); and Miss Allen (Secretary, ASD). The staff team was assisted by Mr. Mountford, the Fund's Resident Representative in Sri Lanka. Mr. Jayawardena, Alternate Executive Director, attended some of the meetings.

Sri Lanka continues to avail itself of the transitional arrangements of Article XIV.

In September 1983, the Executive Board approved a stand-by arrangement for Sri Lanka (EBS/83/166 and Supplement 1) for the period through July 31, 1984 in support of an economic program for 1983/84 (July-June), in the amount of SDR 100 million (56 percent of the then-prevailing quota), half of which was drawn. 1/ As discussed below, performance during the first half of the program, both in terms of short-term stabilization effort and structural policy reforms, was not up to expectations. A review mission, which visited Sri Lanka in November-December 1983, recommended additional measures in the monetary, fiscal, and exchange rate areas as necessary to move the economy toward an appropriate adjustment path in 1984. The authorities explained at that time that in view of the ethnic problem and the current political situation, the Government did not wish to undertake commitments on the economic front which it might not be able to fulfill; consequently, some important economic measures would have to be postponed. Understandings, therefore, were not reached with the authorities on policies, measures, and performance clauses for the second half of the program period and, as a result, Sri Lanka's right to purchase under the arrangement was interrupted. Formal discussions on an IBRD structural adjustment loan were also postponed.

Developments in 1983 and performance under the stand-by arrangement are reviewed in Section III and the report on the discussions is presented in Section IV. As a background to these discussions, Section II briefly reviews the impact of the 1977 economic reforms and the emergence of the main imbalances currently faced by the economy.

1/ SDR 10 million in September 1983, SDR 20 million in November 1983, and SDR 20 million in January 1984.

II. Background

1. The 1977 economic reforms

Economic developments in Sri Lanka over the past decade-and-a half fall into two distinct periods, the watershed being the radical economic reforms initiated in August 1977. Prior to 1977, the economy was characterized by pervasive government controls; consumer subsidies; lack of adequate producer incentives; rationing schemes for major consumer goods; and a dual exchange rate system which discouraged traditional tree crop production for exports (tea, rubber, coconut). In addition, the expectation of the nationalization of tree crop estates and their eventual nationalization in the early 1970s removed incentives for the former owners to invest in the plantations. This, together with a lack of adequate rehabilitation efforts and inefficient management of the estates after the nationalization, led to declining tree crop production and exports. During this period, stringent import controls were the principal tool used to manage the balance of payments situation. The growth performance was poor (real GDP rose by less than 3 percent per annum on average during 1971-77) and unemployment remained high. On the other hand, Sri Lanka achieved high levels of progress in other areas, such as life expectancy, literacy, health, and higher education.

In 1977, a new era of economic policy was inaugurated, as the Government undertook a series of reforms aimed at restoring vitality to the economy by reducing administrative controls; establishing more realistic relative prices by cutting consumer subsidies, thus improving producer incentives; introducing major tax and interest rate reforms; dismantling the trade and payments restrictions; and unifying the exchange rate at a depreciated level. Success was achieved in many areas. By increasing producer incentives, improving the availability of agricultural inputs, and introducing a free market for rice, paddy production expanded rapidly, putting Sri Lanka at the threshold of rice self-sufficiency and contributing importantly toward raising incomes in rural areas. Private investment responded favorably to the new policy incentives and, as a result, significant progress was achieved in eliminating bottlenecks in transportation, increasing industrial output and exports, especially textiles and garments, and developing tourism. These developments, together with the launching of an ambitious public investment program, led to an acceleration of growth and a sharp reduction in unemployment: real GDP rose by an average of 6 percent per year during 1978-83 and the unemployment rate dropped from well over 20 percent in the mid-1970s to 12 percent in 1983. 1/

1/ The 1977 economic reforms were supported by a one-year stand-by arrangement covering 1978, followed by a three-year extended arrangement for the period 1979-81. Performance under the extended arrangement was reviewed in detail in the staff report for the 1982 Article IV consultation (SM/85/155, 7/30/82).

2. The emergence of main imbalances

Some of the policies which contributed to the above achievements have also created problems. The main imbalances that have emerged since 1978 are attributable primarily to a public investment program that was overambitious in size and ill-balanced between economic activities and was accompanied by an inadequate framework of incentives for promoting domestic savings and exports. A failure to adapt policies adequately to the worsening world economy was also a contributing factor.

The principal objective of the Government's investment policy since 1977 has been to improve infrastructure, which was seen as a requirement for sustained and rapid economic growth. The Government launched an ambitious public investment program centering on the Mahaweli hydropower and irrigation project and on an urban development and housing program. As a result, public investment, which averaged less than 8 percent of GDP per year during 1970-77, accelerated to an annual average of over 15 percent of GDP during 1978-83 (Table 1). Private investment showed a similar growth, so that total investment rose from an annual average of 16 percent of GDP in the first period to about 28 percent in the second period.

This rapid acceleration in the rate of investment was not, however, accompanied by any sustained increase in the mobilization of national savings, which, after an initial rise in 1978, remained at 14-16 percent of GDP during the entire period through 1983. In fact, domestic savings declined, so that the level of national savings was maintained only because of a rapid growth in workers' remittances from abroad, mostly from the Middle East.

Both external and domestic factors contributed to the weak savings performance. Five consecutive years of terms of trade deterioration (1978-82) reduced the real incomes of some sections of the population and also adversely affected government receipts from international trade-related taxes, which account for a major part of budgetary revenue. On the domestic side, despite successive increases in nominal interest rates, real interest rates remained negative over most of the period under consideration because of high rates of inflation. In addition, government savings remained negative, mainly because of the lack of adequate progress in expanding the domestic revenue base to offset the adverse impact on revenue of the terms of trade deterioration. The weak financial position of public enterprises also contributed to the weakened public sector savings.

A major part of the increase in investment was financed by external capital inflows in the form of grants and concessional aid as the donor community responded favorably to government efforts to strengthen the economy. But as the world economy deteriorated and national savings stagnated, maintenance of the rapid tempo of development necessitated increasing recourse to external borrowing on commercial terms. In sum,

Table 1. Sri Lanka: Investment, Savings, External Debt Growth, and Inflation, 1970-83

(In percent of GDP unless otherwise specified)

	1970-77 Annual Average	1978	1979	1980	1981	1982	1983	1978-83 Annual Average
Investment 1/	16.0	20.0	25.8	33.8	27.8	30.6	28.6	27.8
Public 2/	7.7	11.1	12.6	20.1	14.8	18.5 3/	15.2 3/	15.4
Private	8.3	9.0	13.2	13.7	13.0	12.1 3/	13.4 3/	12.4
National savings	12.7	15.6	14.8	14.0	14.0	15.4	16.1	15.0
Public 4/	...	-1.4	0.2	-3.8	-1.8	-1.4	-0.1	-1.4
Private 5/	...	17.0	14.5	17.8	15.8	15.9	16.2	16.4
Domestic savings	(...)	(15.3)	(13.7)	(11.3)	(11.6)	(11.9)	(13.5)	(12.9)
Foreign savings	3.3	4.5	11.1	19.8	13.8	15.2	12.5	12.8
External debt	...	37.4	42.3	46.9	52.3	55.7	57.7	48.7
Real GDP (percentage change)	2.9	8.2	6.3	5.8	5.8	5.1	4.9	6.0
Inflation (percentage change) 6/	...	8.8	19.0	37.7	23.9	11.0	11.3	15.4

Source: Data provided by the Sri Lanka authorities.

1/ Including change in stocks.
2/ Including public corporations.
3/ Estimate.
4/ Central Government only.
5/ Including public corporations.
6/ Cost of living index of the Central Bank; year average.

reliance on external savings rose from an annual average of about 3 percent of GDP in 1970-77 to almost 13 percent in 1978-83 (Chart 1). Outstanding external debt rose from 35 percent of GDP in 1977 to 58 percent in 1983, and the debt service ratio almost doubled to about 20 percent. During the same period, outstanding external borrowing on commercial terms rose from less than 2 percent of GDP to almost 20 percent (Chart 2).

Against this background of a rising external debt service burden, Sri Lanka's performance in developing sources of foreign exchange earnings was, on the whole, disappointing. In particular, the volume of tree crop exports remained stagnant or continued to decline, while nontraditional exports, after a strong initial increase in 1978-81, recorded only sluggish growth. A notable exception was garment exports, which continued to rise rapidly throughout the period. Two other successful areas were tourism and workers' remittances, the growth of which, however, slowed considerably after 1981.

Several factors contributed to the slow overall growth of exports. First, the Government's strategy of concentrating its investment program on infrastructure projects with long gestation periods came at the expense of the maintenance of existing assets, particularly in the export sector. Nowhere is this more evident than in the lack, until recently, of concentrated effort to rehabilitate the tree crop sector which accounts for over 10 percent of GDP and over half of exports. Second, even though export promotion zones were set up, the general framework of incentives, including insufficient exchange rate flexibility and an effective protection system that introduced a bias against exports, has encouraged investment in trade, construction, real estate, and inefficient import substitution at the expense of investment in exports. Finally, other factors, such as poor marketing facilities, insufficient knowledge of foreign markets, etc., also hampered the development of nontraditional exports.

In conclusion, the crux of the external adjustment problem now facing Sri Lanka is that the increased reliance on foreign savings has not been accompanied by comparable gains in exports to service the associated increase in external debt. The Mahaweli project will, of course, contribute toward achievement of a viable balance of payments by enhancing agricultural production and import substitution in energy. 1/ However, given the limited size of the domestic market, Sri Lanka also needs to promote a strong growth in exports.

1/ Construction of the Victoria dam, a major part of the Mahaweli project, was completed at the end of 1983, and power generation is scheduled to start in mid-1984. Work on another major dam project (Kotmale) is progressing on schedule and power generation is expected to start in early 1985 (see associated Recent Economic Developments to be issued shortly).

III. Developments in 1983 and Performance Under the Stand-By Arrangement

The economic program supported by the 1983/84 stand-by arrangement was seen as a significant step in the fundamental adjustment required by the situation. The main macroeconomic objectives of the program were to reduce the external current account deficit from 15 percent of GDP in 1982 to about 12 percent in 1983 and 10 percent in 1984; and to slow the rate of inflation to 10-11 percent by end-1983, and further to 8 percent by mid-1984. Aggregate output growth was projected at 4.6 percent in 1983 and 5.5 percent in 1984. The principal policies under the program consisted of a 5 percent depreciation of the rupee in July 1983, to be followed by a flexible exchange rate management; reductions in both the overall budget deficit and its domestic financing; and a tightening of the overall credit stance. Recognizing the need for policies to correct the structural weaknesses, the program also contained specific undertakings by the authorities to initiate structural reforms in four areas: plantations; public investment; tax policy; and effective protection.

Although the fiscal and external current account deficits declined markedly and all the quantitative performance criteria were met (Table 2), 1/ economic performance fell short of targets in some important areas. These include a much higher rate of domestic inflation and a smaller-than-envisaged improvement in the external current account balance, notwithstanding considerably higher-than-anticipated export prices (Table 3). Progress on structural reforms was also slower than expected.

1. External developments

The external current account deficit declined from over 15 percent of GDP in 1982 to 12.5 percent in 1983, compared with 12 percent targeted under the program; the overall balance was in approximate

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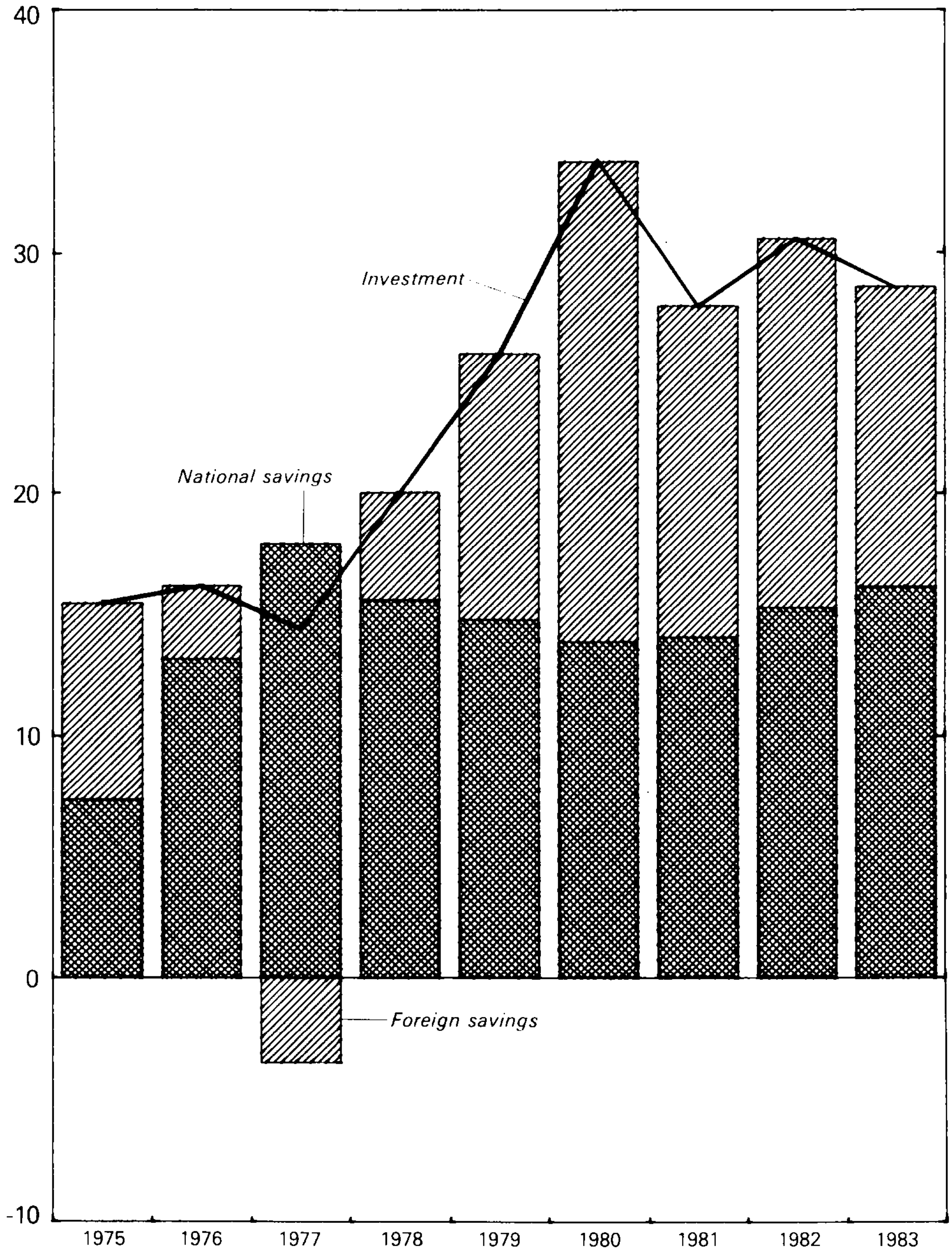
1/ The stand-by arrangement contained the following performance criteria: (i) ceilings on net domestic assets of the banking system and credit to the public sector; (ii) limits on the contracting of public or publicly guaranteed foreign loans on commercial terms with 1- to 12-year maturities and on the amount of outstanding short-term debt; (iii) quarterly tests of the exchange rate of the rupee consistent with a predetermined formula; (iv) the standard provisions relating to the exchange and trade system; and (v) a mid-term review before January 31, 1984 of performance and policies, particularly in the exchange rate, interest rate, and budget areas, as well as the progress made in the implementation of the structural reforms. The quantitative performance criteria were set for end-August and end-November 1983; such performance criteria for the second half of the program were to be set at the time of the mid-term review.

CHART 1

SRI LANKA

FINANCING OF INVESTMENT, 1975-83

(In percent of GDP)

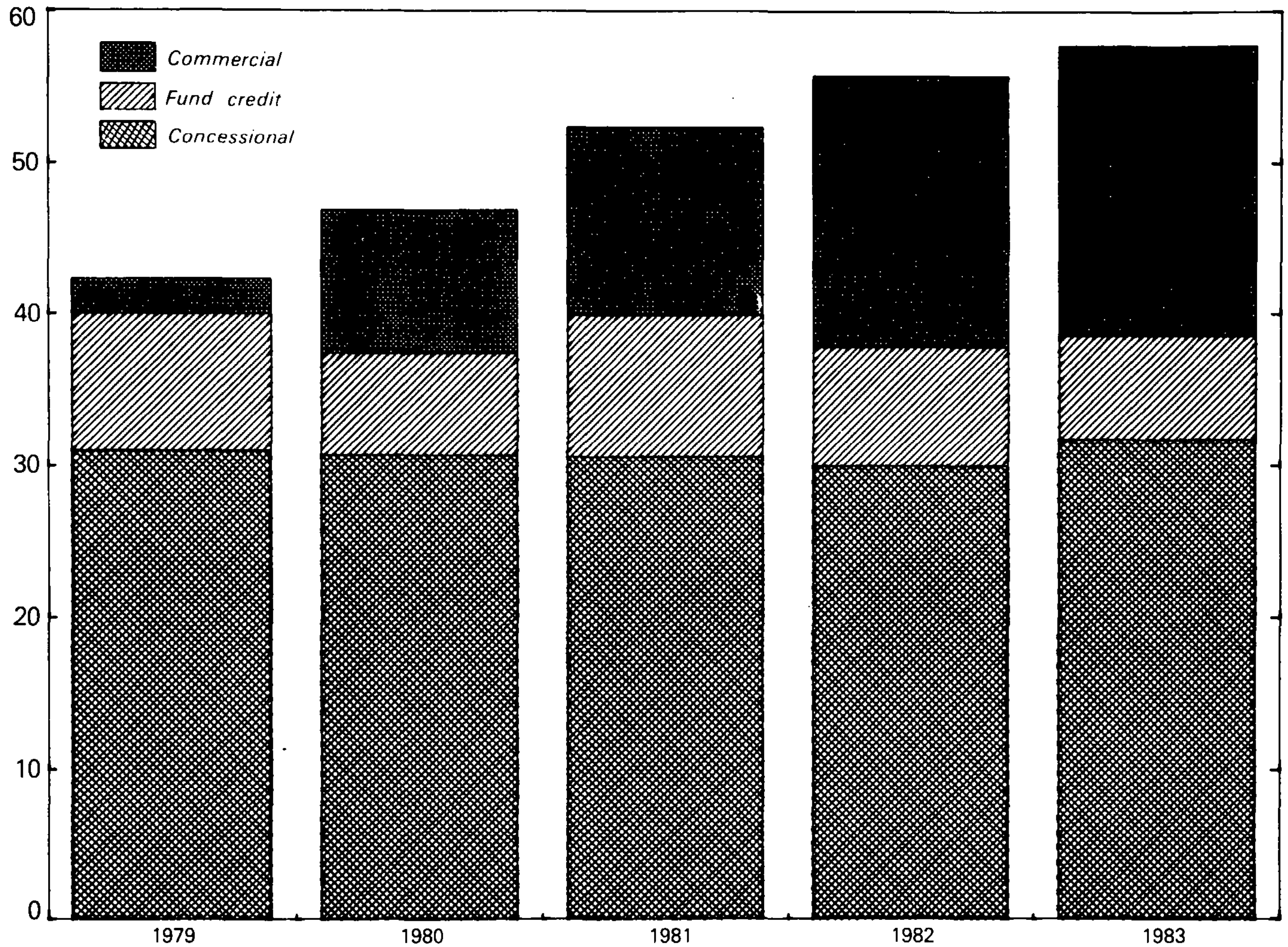


Source: Data provided by the Sri Lanka authorities.

CHART 2

SRI LANKA

OUTSTANDING DEBT AS PERCENT OF GDP, 1979-83



Source: Data provided by the Sri Lanka authorities.

Table 2. Sri Lanka: Quantitative Performance Criteria Under 1983 Stand-By Arrangement

End of Period	July 1983	Aug.	Sept.	Oct.	Nov.	Dec.
	(In millions of Sri Lanka rupees)					
I. Domestic credit						
Net domestic assets						
Actual	34,969	34,386	36,168	36,830	35,657	36,992
Ceiling		34,500			36,000	
Credit to public sector 1/						
Actual	21,346	20,933	22,144	22,076	20,853	22,024
Ceiling		22,000			22,300	
	(In millions of SDRs)					
II. Foreign borrowing limits						
New commitments in 1- to 12-year maturity (cumulative) 2/						
Actual	--	--	--	--	--	--
Ceiling		50			50	
Outstanding short-term debt 3/						
Actual	288	274	283	311	272	236
Ceiling		325			301	
III. Exchange rate		test met 4/			test met 4/	

Source: Data provided by the Sri Lanka authorities.

1/ Defined as credit to the Government (net) plus credit to public corporations.
2/ Nonconcessional borrowings contracted or guaranteed by the public sector cumulative from June 1, 1983.
3/ Defined as outstanding short-term borrowings by Central Bank of Ceylon plus external borrowings by commercial banks plus acceptance credits by the Ceylon Petroleum Corporation.
4/ The level of the exchange rate of the rupee tested against the results provided by a formula using a trade-weighted nominal effective exchange rate index adjusted for relative price movements in Sri Lanka and trading partners.

Table 3. Sri Lanka: Selected Economic and Financial Indicators, 1980-84

	1980	1981	1982	1983 Program	1983 Outcome	1984 Official Forecast
				(Changes in percent)		
Real GDP	5.8	5.8	5.1	4.6	4.9	5.7
GDP deflator	18.2	20.5	9.9	13.0	15.7	10.0
Consumer prices (end-year)	28.2	23.5	1.4	10.0	22.0	10.0
Export volume	-5.1	6.6	5.8	-5.0	-4.6	8.5
Import volume	13.3	-10.4	11.2	--	1.1	1.4
Terms of trade	-8.5	-8.5	-5.6	10.9	15.0	12.8
Effective exchange rate (depreciation -)						
Nominal	-17.9	-3.6	5.4		-10.4	
Real (adjusted WPI)	-2.1	12.9	-2.0		-2.5	
Real (CPI)	-3.8	10.0	2.5		4.8	
Budget revenue	10.3	15.1	8.9	36.7	43.1	31.4
Budget expenditure	48.7	-0.2	19.0	15.0	18.2	8.9
Net domestic credit	81.0	32.7	25.1	13.4	16.5	8.1
Government (net)	207.2	41.6	33.7	1.7	2.3	-10.3
Private sector	57.7	34.0	24.1	24.0	33.8	18.4
Broad money	31.8	23.2	24.5	14.9	21.7	15.0
				(In percent of GDP)		
Budget						
Deficit before grants	23.1	15.6	17.2	13.6	13.4	8.9
Deficit after grants	19.2	12.4	13.8	10.4	10.6	5.9
Revenue	19.9	18.0	16.6	18.9	19.4	22.3
Expenditure	43.0	33.5	33.8	32.5	32.8	31.2
Domestic financing	13.9	6.6	9.1	3.7	5.4	1.3
Current account deficit, excluding grants	19.8	13.8	15.2	12.0	12.5	8.4
Current account deficit, including grants	16.4	10.2	11.8	8.6	9.2	5.3
External debt	46.9	52.3	55.7		57.7	61.8
Debt service in percent of:						
Exports of goods and services	12.2	16.5	18.4	21.6	22.0	19.2
Current account receipts	11.1	14.4	15.3	17.9	18.4	16.4
				(In millions of SDRs)		
Exports	818	903	918	960	987	1,244
Imports	1,576	1,597	1,808	1,730	1,791	1,872
Current account	-613	-517	-663	-550	-606	-422
Overall balance	-166	-26	-18	-19	---	109
Gross official reserves (months of imports)	1.5	1.9	2.1	2.0	1.9	2.3
External debt	1,448	1,958	2,426	2,767	2,805	3,143
Debt service payments	126	193	224	280	287	304

Sources: Data provided by Sri Lanka authorities; and staff estimates.

equilibrium, compared with a deficit of SDR 18 million in 1982 and of SDR 19 million envisaged under the program (Table 4 and Appendix Table 8). An important development affecting the balance of payments has been the rapid increase in the world prices of tea (accounting for about a third of Sri Lanka's exports) since the fourth quarter of 1983 (Chart 3). 1/ As a result, Sri Lanka's average tea export price in 1983 was about 40 percent higher than in 1982. In addition, the average export prices for rubber and coconut rose by 17 percent and 23 percent, respectively. This, combined with a slight decline in import prices, resulted in a 15 percent improvement in Sri Lanka's terms of trade during 1983, representing an estimated gain in the trade account equivalent to more than 3 percent of 1983 GDP.

The reduction in the current account deficit was considerably less than the gains from the improvement in the terms of trade. There were adverse exogenous factors affecting the balance of payments in 1983. Tourist receipts declined sharply following the July 1983 ethnic disturbances which also prompted some capital outflows. The decline in the production of tea, as well as that of coconut products, also affected the balance of payments by preventing Sri Lanka from reaping the full benefits of the increase in export prices, although world tea prices would not have risen as much had Sri Lanka had a normal year of tea production. 2/ But slippages in demand management also contributed to the less-favorable-than-programmed balance of payments outcome. Thus, imports, although lower than in 1982, were larger than envisaged under the stand-by program, mainly owing to an expansionary credit policy that added to the demand effect of the improvement in the terms of trade. Furthermore, nontraditional exports remained sluggish which can be attributed, at least in part, to the inadequate framework of incentives for exports.

The larger-than-targeted current account deficit was financed by higher-than-anticipated commercial borrowing, partly through borrowing

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1/ From an average of US$2.02 per kg. in the first three quarters of 1983, world tea prices rose to an average of $3.23 per kg. in the final quarter of 1983. Prices surged further in January 1984, but declined somewhat in the subsequent two months. Nevertheless, at $3.72 per kg., the average price in the first quarter of 1984 was 84 percent higher than the average price during the first three quarters of 1983. In part, the increase in prices reflected a shift in the demand-supply situation arising from two main factors: (i) an increase in demand in India and other Asian countries where the income elasticity of the demand for tea is relatively high; and (ii) a slow growth in world production mainly due to a decline in production in Sri Lanka and sluggish output in India, as both countries were affected by drought. The sharp increase in tea prices also reflected market reaction to the ban imposed in late 1983 by India on the export of a major type of processed tea (CTC tea) in order to meet local demand.

2/ Sri Lanka accounts for over 20 percent of world tea exports.

Table 4. Sri Lanka: Selected External Indicators, 1980-84

(In millions of SDRs, unless otherwise indicated)

	1980	1981	1982	1983 Program	1983 Outcome (Prel.)	1984 Official Projections
Exports, f.o.b.	818	903	918	960	987	1,244
Imports, c.i.f.	-1,576	-1,597	-1,808	-1,730	-1,791	-1,872
Tourism receipts	76	99	117	120	96	100
Other services, net	-36	-94	-129	-160	-154	-161
Private transfers	105	172	239	260	256	267
Current account	-613	-517	-663	-550	-606	-422
(As percent of GDP)	(-19.8)	(-13.8)	(-15.2)	(-12.0)	(-12.5)	(-8.3)
Overall balance	-166	-26	-18	-19	--	109
Memorandum items:						
Gross official reserves (year-end)						
In months of imports	1.5	1.9	2.1	2.0	1.9	2.3
External debt service as percent of:						
Exports of goods and services	12.2	16.5	18.4	21.6	22.0	19.2
Current account receipts 1/	11.1	14.4	15.3	17.9	18.4	16.4

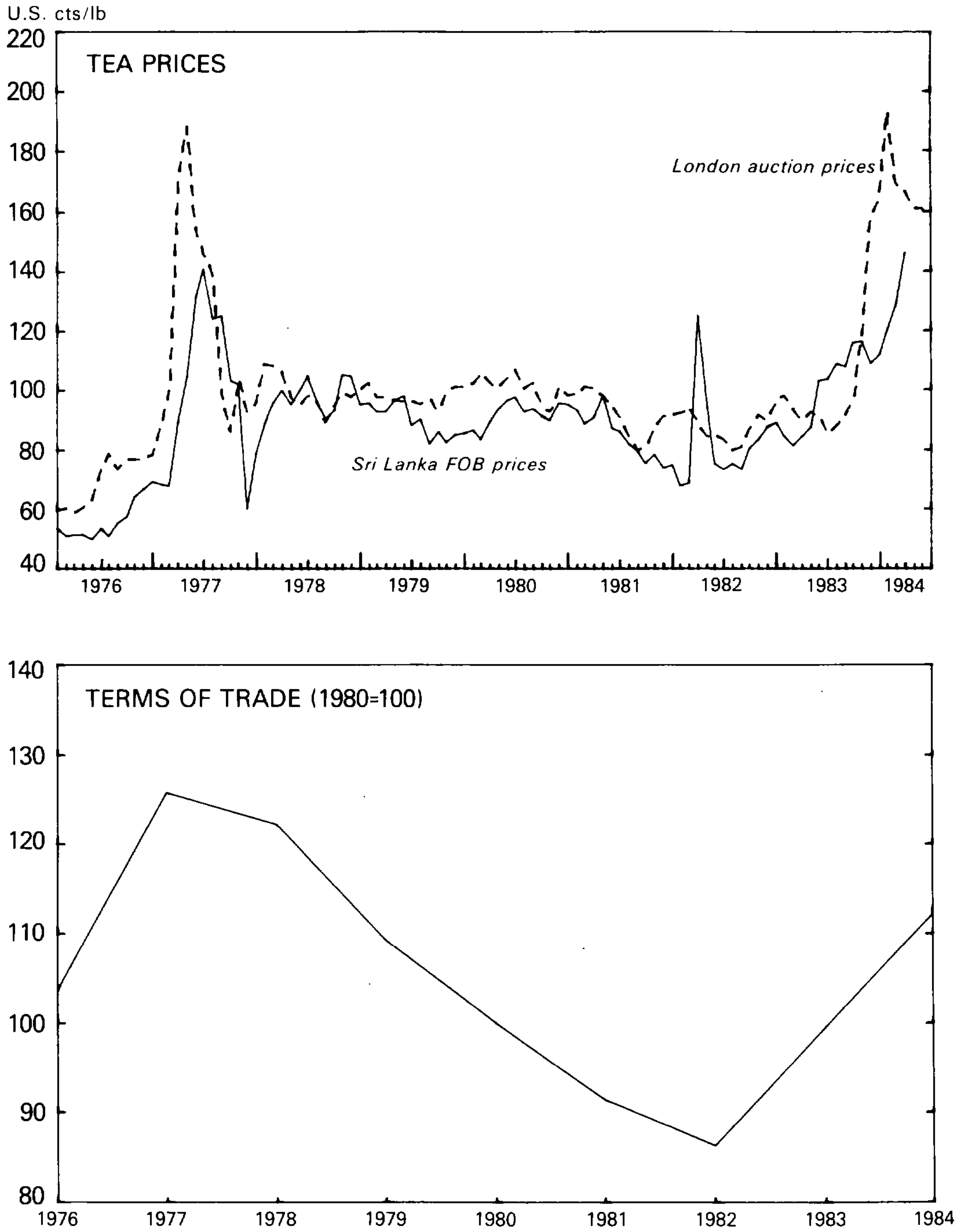
Source: Data provided by the Sri Lanka authorities.

1/ Exports of goods and services plus private transfers.

CHART 3

SRI LANKA

TEA PRICES AND TERMS OF TRADE



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

by nonbank residents from Foreign Currency Banking Units (FCBUs). Part of such borrowings was not covered by the stand-by limits on foreign debt because of the lack, at that time, of information on the maturity structure of FCBU lending and the difficulties in monitoring disbursements of loans from these units. 1/ However, Central Bank approvals for lending by FCBUs to residents have been cut since late 1983, which would be reflected in a decline in outstanding disbursements during 1984.

Following the 5 percent depreciation in July 1983, the exchange rate of the rupee has been adjusted on the basis of a formula which takes into account relative price movements, as measured by the wholesale price index (WPI) in Sri Lanka and major trading partners. 2/ Between end-July 1983 and end-April 1984, the nominal effective exchange rate for the rupee depreciated by about 4 percent (Chart 4). If the WPI is used as domestic cost indicator, the real effective exchange rate moved upward during the last five months of 1983, but fell during the first four months of 1984; for the period as a whole, therefore, it remained approximately unchanged. On the other hand, if the CPI (to which most wages in Sri Lanka are indexed) is used, the real effective exchange rate appreciated by about 6 percent between end-July 1983 and end-April 1984.

2. Domestic financial developments and prices

a. Monetary and price developments

Total domestic credit expansion declined from 25 percent in 1982 to 17 percent in 1983 (Table 5 and Appendix Table 9), but was higher than the 13 percent increase envisaged under the program. The higher-than-targeted credit expansion, together with the inflow of funds from the external sector in the latter part of the year (Chart 5), led to a sharp acceleration in the growth of liquidity and an upsurge in inflation. Liquidity expansion accelerated from an annual rate of 15 percent in June 1983 to 22 percent in December, compared with 15 percent targeted under the program; during the same period, the rate of inflation increased from 13 percent to 22 percent. While there were special factors contributing to the higher rate of inflation--such as administered price adjustments, increases in export prices for tea and coconuts, the depreciation of the rupee, and the impact of disturbances on domestic supplies--a major underlying factor was the rapid expansion in domestic liquidity.

Public sector credit remained virtually unchanged during 1983, but credit to the private sector increased sharply. Though the need to meet special credit requirements in the aftermath of the July disturbances

1/ Borrowing from FCBUs not covered by foreign debt limits increased by SDR 26 million in 1983.

2/ For Sri Lanka, the WPI is adjusted to exclude export commodity prices.

Table 5. Sri Lanka: Monetary Developments, 1982-84

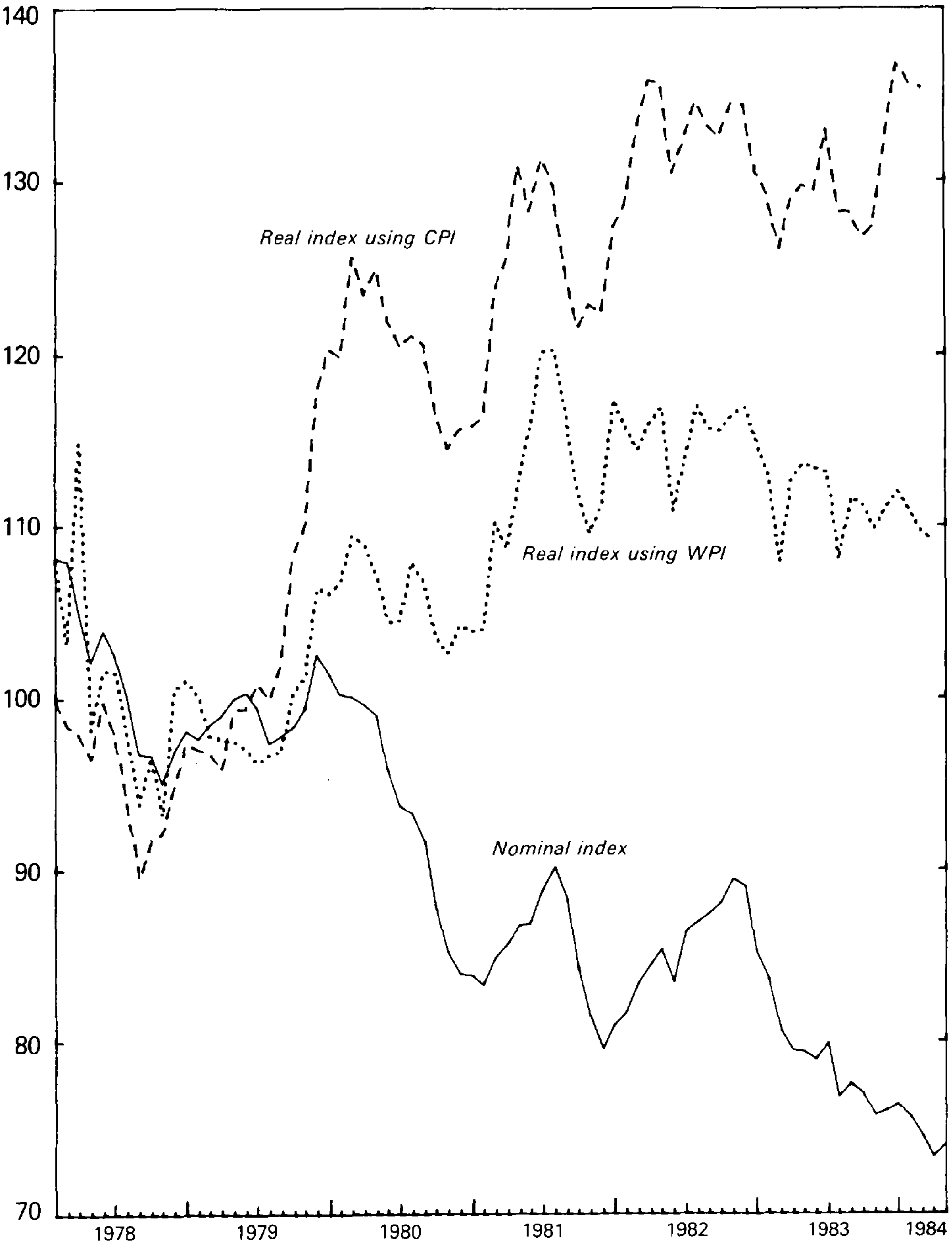
End of Period	1982 Dec.	1983 March	1983 June	1983 Sept.	1983 Dec.	1984 March
		(In millions of Sri Lanka rupees)				
Net foreign assets	-718	-1,114	-2,360	-2,057	-150	1,872
Domestic credit	42,188	44,632	45,575	48,034	49,152	48,670
Government	(17,236)	(17,064)	(17,491)	(17,586)	(17,639)	(15,662)
Public corporations	(4,677)	(4,818)	(4,331)	(4,558)	(4,385)	(4,676)
Private sector	(20,275)	(22,750)	(23,753)	(25,890)	(27,128)	(28,332)
Broad money	30,249	32,625	32,509	34,136	36,818	39,292
Other items, net	11,223	10,893	10,706	11,841	12,184	11,250
		(Annual percentage change)				
Domestic credit	25.1	19.0	14.6	16.9	16.5	9.0
Public sector credit	26.1	9.7	0.8	-1.3	0.5	-7.1
Private sector credit	24.1	29.5	30.9	38.7	33.8	24.5
Broad money	24.5	17.1	14.9	15.1	21.7	20.4

Source: Data provided by the Central Bank of Ceylon.

CHART 4

SRI LANKA

SRI LANKA-EFFECTIVE EXCHANGE RATES[1]
(1978-79=100)



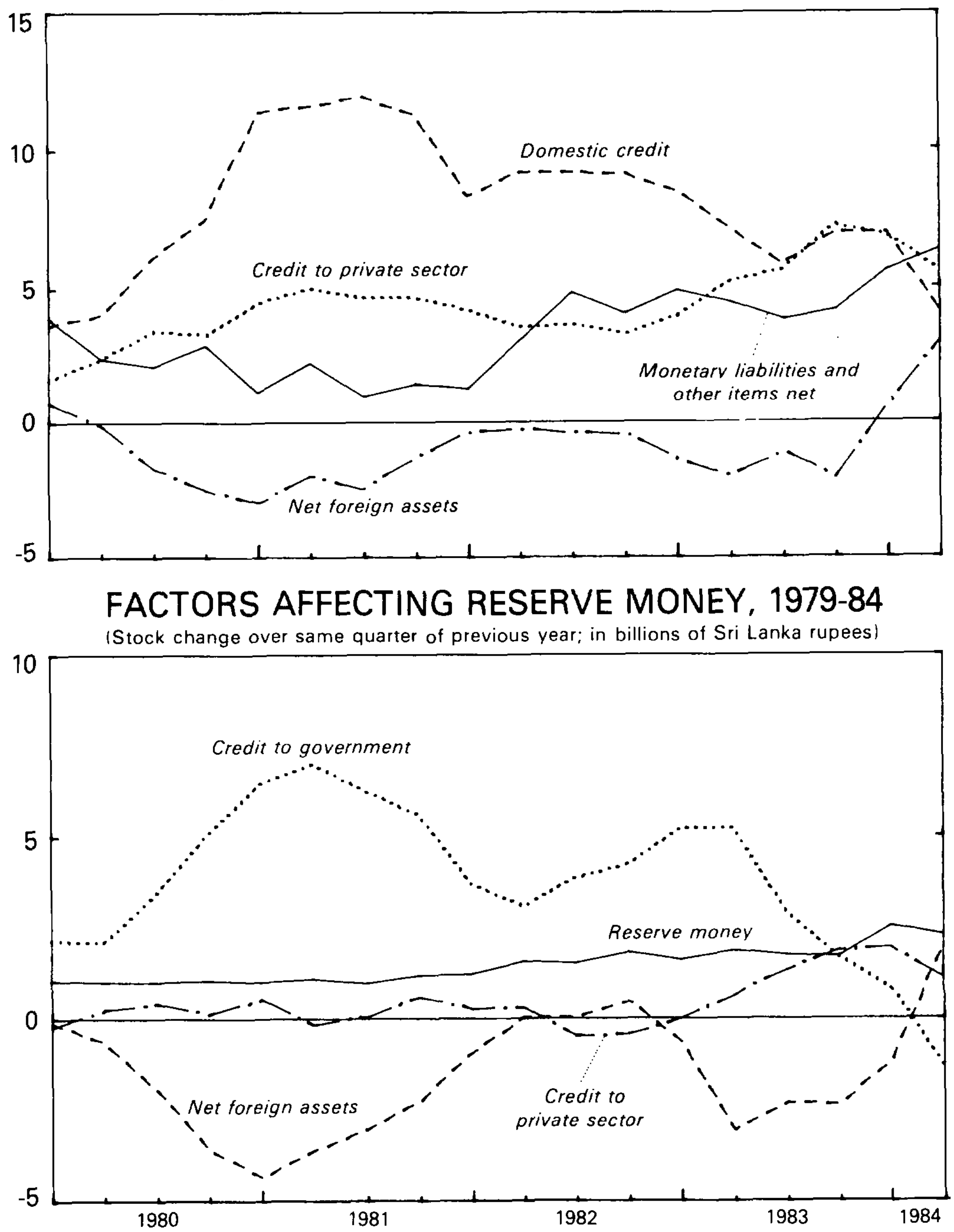
Source: Staff calculations.
[1]An increase in the index indicates appreciation.

CHART 5

SRI LANKA

FACTORS AFFECTING MONEY SUPPLY, 1979-84

(Stock change over same quarter of previous year; in billions of Sri Lanka rupees)



Source: Data provided by the Central Bank of Ceylon.

explains some of the rapid growth of private sector credit, the general stance of credit policy was expansionary. Almost a quarter of the growth in private sector credit during 1983 was financed by increased Central Bank rediscounting at concessional interest rates to the private sector, mostly for exports. The authorities explained that access to rediscounting by traditional exporters, particularly of tea, was enlarged in order to allow them to compete with other tea exporters who benefited from concessional financing in their own countries.

Reflecting the accommodating stance of monetary policy, credit to the private sector was, by end-September, almost 40 percent higher than a year earlier. In late October, the Central Bank introduced several credit-restraint measures, including a freeze on commercial bank advances other than for exports to the private sector, accompanied by some tightening of rediscount facilities. In early December, the credit freeze was lifted, but reserve requirements for banks were raised by 2 percentage points. Nevertheless, credit to the private sector continued to expand at a rapid pace during the last quarter of 1983 and, at the end of the year, it was still 34 percent higher than a year earlier, exceeding the program target by 8 percent.

Although the ceilings set under the stand-by arrangement on the net domestic assets (NDA) of the banking system for end-August and end-November were met, on both occasions NDA exceeded the program limits before and after the testing dates (Chart 6). In both instances, the ceilings on NDA were observed because of a temporary decline in net domestic credit to the public sector. In August, capital expenditure slowed due to the civil disturbances. In November, the Government drew on an external loan contracted earlier and there was also a catch up in foreign aid disbursements. The subsequent increase in public sector credit in December was due to the normal speedup of expenditures in the last month of the fiscal year.

b. Fiscal developments

The budget deficit declined to 13.4 percent of GDP (10.6 percent after foreign grants) in 1983 (Table 6 and Appendix Table 10); excluding the transfer of Central Bank profits, which were included in government receipts for the first time in 1983, the reduction was equivalent to about 2.5 percent of GDP. Tax revenue increased by about 1.5 percent of GDP, mainly as a result of increases in the business turnover tax (BTT) rates and the imposition of import duties on some previously exempted goods. At the same time, total expenditure declined by 1 percent of GDP, owing to a reduction in investment outlays, as the Government continued to scale down its investment program to more sustainable levels.

Total revenue exceeded the level contemplated in the stand-by program by Rs 1 billion (5 percent), mainly due to higher receipts from the BTT, export taxes, and nontax revenue. On the other hand, expenditure

Table 6. Sri Lanka: Summary of Central Government Operations, 1982-84

(As percent of GDP)

	1982	1983		1984	
		Program	Actual	Budget	Revised
Revenue	16.6	18.9	19.4	20.6	22.3
Of which: taxes	(15.4)	(16.6)	(16.9)	(17.8)	(19.3)
Expenditure	33.8	32.5	32.8	30.8	31.2
Current (incl. advance accounts)	18.0	19.6	19.5	19.0	18.8
Capital	15.8	12.9	13.3	11.8	12.4
Deficit before grants	-17.2	-13.6	-13.4	-10.1	-8.9
(Excluding Central Bank profits)	(-17.2)	(-14.8)	(-14.6)	(-11.3)	(-10.1)
Deficit after grants	-13.8	-10.4	-10.6	-7.2	-5.9
(Excluding Central Bank profits)	(-13.8)	(-11.6)	(-11.8)	(-8.4)	(-7.1)
Domestic borrowing	9.1	3.7	5.4	2.5	1.3

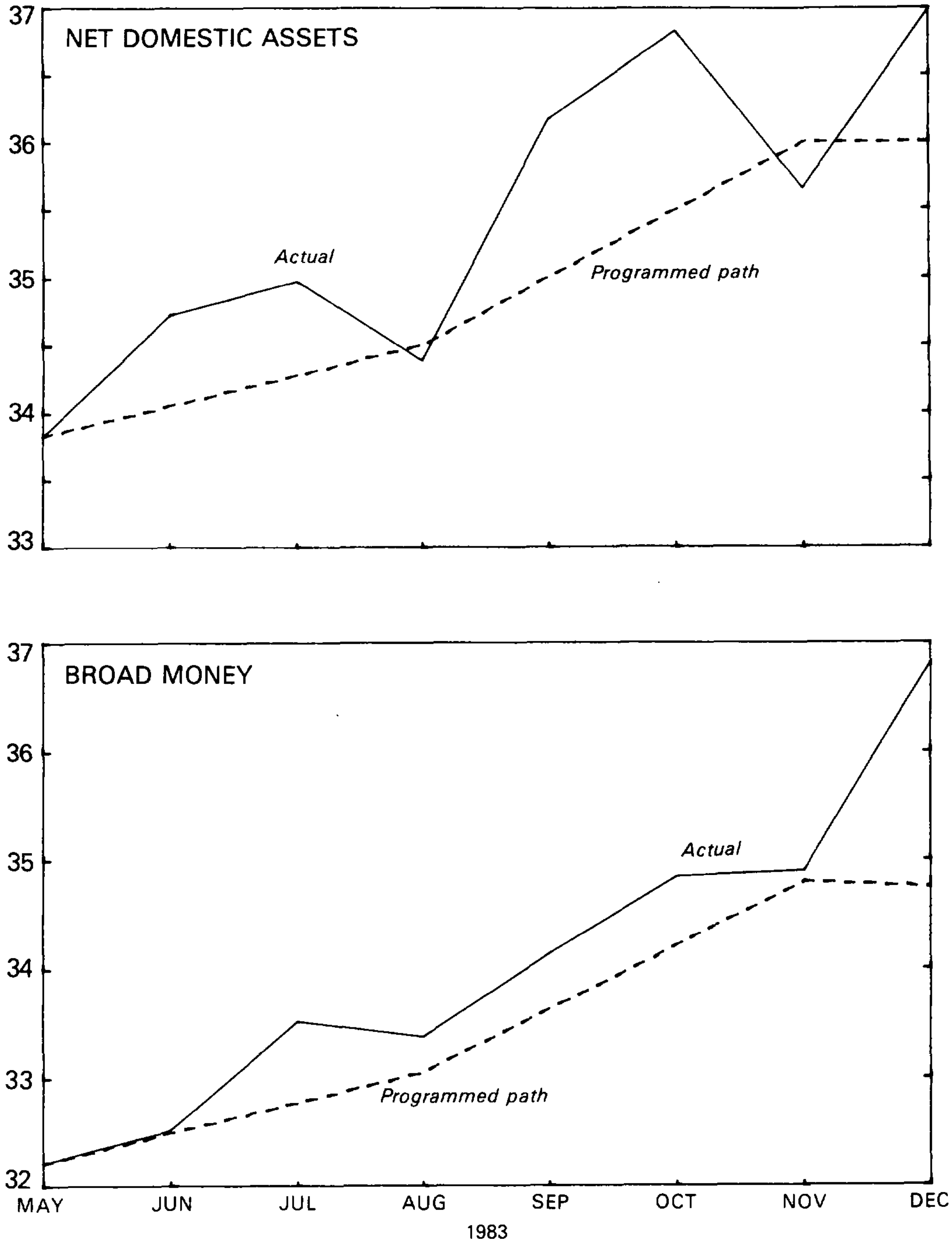
Source: Data provided by the Sri Lanka authorities.

CHART 6

SRI LANKA

MONETARY AND CREDIT DEVELOPMENTS: PERFORMANCE UNDER STAND BY ARRANGEMENT

(In billions of Sri Lanka rupees)



Source: Data provided by the Sri Lanka authorities.

also exceeded the program target by about Rs 1 billion (3 percent), owing to higher Treasury advances to public corporations and larger investment outlays. While the budget deficit was thus the same as foreseen under the program, there was a considerable deviation in the financing of the deficit. In the course of the year, the Government undertook investment outlays not contemplated under the program, which, together with a shortfall in aided project implementation, led to a much larger-than-envisaged borrowing from domestic nonbank sources. Even though net recourse by the Government to the domestic banking system was limited to the program target of 0.4 percent of GDP (compared with 3.7 percent in 1982), borrowing from domestic nonbank sources, mostly from the National Savings Bank and the Employees Provident Fund, exceeded the program target by nearly 2 percentage points of GDP. Together with the expansionary credit policy stance vis-a-vis the private sector, this deviation in the deficit financing contributed to the pressure on domestic prices and the less favorable outcome in the balance of payments.

3. Growth situation

Real GDP grew by 4.9 percent in 1983, slightly less than in 1982. Provisional data indicate that the rate of investment declined, owing to a decline in public investment. Private investment appears to have risen, although the investment climate was adversely affected by the ethnic disturbances. The rate of domestic savings increased, reflecting the income-enhancing impact of the improvement in the terms of trade. In combination, the lower level of investment and higher level of domestic savings reduced reliance on foreign savings.

Output growth accelerated in the agricultural sector, as a record growth in paddy production and an increase in other sectors more than offset a drought-induced decline in tea and coconut production (Appendix Table 11). On the other hand, growth in manufacturing dropped to less than 1 percent, due to (i) a decline in tea and coconut processing; (ii) power shortages as a result of a decrease in hydropower generation caused by the drought; (iii) a prolonged shutdown of the petroleum refinery; (iv) the suspension of operations of certain large loss-making state factories (e.g., urea plant); and (v) a loss of production owing to destruction, curfew, and shorter working hours following the July 1983 disturbances. These disturbances also adversely affected activity in the services sector.

Although the full impact of the disturbances is difficult to assess, its effect on the economy was pervasive. Rough estimates suggest that direct damage caused by destruction of physical assets, such as dwellings, shops, warehouses, and factories could amount to \$300 million. In manufacturing, the heaviest damage was inflicted on the textile and garment industry; exports, however, were not seriously affected as the undamaged units were able to honor foreign contracts. On the other hand, tourist arrivals dropped sharply in the months following the disturbances as many bookings were canceled; the loss in tourist earnings has been estimated at $40 million in 1983, but the impact will also be felt in 1984. The direct effect of the disturbances on employment has been estimated at a loss of at least 50,000 jobs. In addition to these measurable impacts, the disorders had an effect on investors' confidence and slowed down work in public works as a result of the departure of skilled Tamil workers.

IV. Policy Discussions

1. Medium-term adjustment need

Current policies were reviewed against the perspective of the adjustment need facing Sri Lanka. In discussing the medium-term balance of payments outlook, the staff and the authorities agreed on two basic trends. First, the growth of production of traditional exports is constrained by the availability of land and the long gestation period of any rehabilitation effort; although there is ample room for raising yields in the tree crop sector in the longer term, there will be only relatively modest growth in output until about the end of the decade when the medium-term investment program about to be launched in the plantation sector will begin to yield results. Second, an increase in external debt service obligations, together with an expected leveling-off of gross foreign aid inflows as the Mahaweli-related aid is phased out, will cause net capital inflows to decline sharply as a ratio of GDP. 1/ Staff projections indicate that the external debt service ratio will increase from 19 percent of exports of goods and services in 1984 (16 percent when workers' remittances are included) to a peak of almost 27 percent (23 percent) in 1987-88, of which over 4 percent will represent payment obligations to the Fund (Table 7).

On the basis of the above trends, the staff projects a decline in net capital inflows from about 13 percent of GDP in 1983 to approximately 6 percent by 1988-90 (Appendix Tables 12 and 13); given the need to limit the recourse to external borrowing on commercial terms, these projections assume a gradual decline in gross commercial borrowing from 5 percent of GDP in 1983 to about 2 percent by the end of the decade. Allowing for some increase in external reserves to maintain their level at the equivalent of about two months of imports, staff projections indicate that the current account deficit will need to be reduced to about 5 percent of GDP by the end of the 1980s. 2/

1/ The foreign aid component of the Mahaweli project is officially projected to decline from Rs 4.9 billion in 1984 (equivalent to about 10 percent of imports) to about Rs 500 million in 1988.

2/ These projections take into account the servicing of new debt consistent with the above adjustment path.

Table 7. Sri Lanka: Medium-Term Balance of Payments and Debt Service Outlook, 1983-1990

(As percent of GDP)

	Prel. 1983	1984	1985	1986	1987	1988	1989	1990
Current account	-12.5	-8.3	-8.4	-7.0	-6.0	-5.1	-4.8	-4.8
Exports	20.3	24.5	22.8	22.4	22.6	23.0	23.4	23.8
Imports	-36.8	-36.8	-34.7	-32.6	-31.9	-31.4	-31.6	-32.1
Other, net	4.1	4.0	3.5	3.2	3.3	3.3	3.4	3.5
Capital account	12.5	10.4	9.6	8.2	7.0	6.5	6.4	6.3
Overall balance	--	2.1	1.2	1.2	1.0	1.4	1.6	1.5
External debt service payments	5.9	6.0	6.8	7.5	8.0	7.8	6.9	6.4
External debt service payments as percent of:								
Exports of goods and services	22.0	19.2	22.8	25.3	26.9	25.9	22.8	20.9
- Current account receipts 1/	18.4	16.4	19.5	21.7	23.2	22.5	19.9	18.3

Sources: Data provided by the Sri Lanka authorities; and Fund staff estimates.

1/ Exports of goods and services plus private transfers.

The authorities are in broad agreement with these projections. They plan to achieve the required medium-term adjustment both through scaling down the public investment program and reorienting it to more directly productive sectors, and through measures aimed at increasing domestic savings. While this would contribute to external adjustment, export performance will also have to be improved to ensure adequate adjustment and economic growth. Given the constraints on the growth of traditional exports--such exports are forecast to grow by only about 2 percent per year in volume terms through the end of the decade--the increase in exports will have to come from a strong growth of nontraditional exports. In addition, efforts will have to continue to increase tourism and develop efficient import substitution.

It is against the background of these medium-term adjustment goals that current policies need to be assessed.

2. Objectives and policies in 1984

a. Objectives

For 1984, the authorities forecast a reduction in the current account deficit to approximately 8.5 percent of GDP and a surplus of about SDR 110 million in the overall balance. Reflecting the higher level of world commodity prices and the recovery in tree crop output, exports are expected to increase by 26 percent. The growth of imports, on the other hand, is targeted to be contained to only 5 percent, the restraint to be achieved mainly through an expected improvement in the fiscal position and a tightening of monetary policy. Capital inflows are projected to decline, mostly on account of lower commercial borrowings.

Sri Lanka's terms of trade are projected to show a further improvement of about 13 percent in 1984, representing a gain in the trade account equivalent to over 2 percent of GDP. It is expected that the current high level of tea prices will not be sustained for long because of the anticipated recovery of production in Sri Lanka and India and the incentives the high prices provide to increase yields in tea farms and plantations. The projections of the authorities assume a decline in tea prices by the end of 1984 to approximately their average level in the last quarter of 1983. Nevertheless, because of the high level of prices in the first part of the year, Sri Lanka's average tea export price in 1984 is still expected to be about 30 percent higher than in 1983. In addition, average rubber and coconut prices are also expected to be significantly higher in 1984 than in 1983.

If achieved, the 1984 balance of payments target would represent a considerable improvement in the external accounts, which would allow a buildup of foreign exchange reserves to more comfortable levels and a reduction in commercial borrowing. However, the improvement should not mask the continued underlying weaknesses in the balance of payments.

Indeed, the bulk of the reduction in the current account deficit would come from an increase in the terms of trade and a recovery of the tree crop production from drought.

The authorities' price objective is to reduce the rate of domestic price increase to below 10 percent by the end of 1984. They also forecast a rate of real GDP growth of 5.7 percent. Agricultural output growth is projected to accelerate as a result of a recovery of tea and coconut production from the drought, while manufacturing output is expected to expand considerably on the strength of an increase in both external and domestic demand.

b. Policies

(1) Monetary policy

Despite the credit restraint measures taken toward the end of 1983, liquidity expansion and inflation remained at an annual rate of over 20 percent during the first quarter of 1984, as a result of a further sharp increase in net foreign assets of the banking system and a continued rapid growth (25 percent annual rate) in private sector credit. Although Central Bank rediscounting declined somewhat in the first quarter of 1984, banks by then had become so liquid that they could accommodate the continued strong private sector demand for credit from their own resources. The Central Bank took further credit-restraint measures in March when a ceiling was placed on advances for nonessential imports, and again in May, when a 5 percent ceiling on the growth of certain other private sector credit was imposed. Advances for exports and agriculture, which account for about one third of total private sector credit, were exempted from this ceiling. At the same time, it was announced that the Central Bank would soon start auctioning off stabilization bonds to mop up excess liquidity. The authorities estimate the excess liquidity at Rs 1.5-2.0 billion, or 4-5 percent of broad money.

The staff team welcomed these measures but indicated that, given the magnitude of the liquidity overhang and the increase in inflationary expectations, stronger measures were needed to achieve the authorities' objective of bringing down the rate of inflation to below 10 percent by the end of 1984 and of containing the demand for imports at the targeted level. The staff recommended that the Central Bank substantially tighten its rediscounting policy, particularly to the tree crop sector which did not need concessional financing at a time of high commodity prices. Furthermore, in order to reduce distortions, the interest rate paid on government paper should be raised to market levels. 1/ Such measures would lead to an increase in the general level of interest

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1/ Treasury bills currently carry an interest rate of 12 percent per year, while comparable deposit rates with commercial banks are in the range of 15-25 percent.

rates which the staff believes is necessary given the high rate of inflation and strong demand for credit. Without such an increase, the 5 percent ceiling imposed on the growth of certain private sector credit will provide strong incentives for a misallocation of resources. The authorities explained that under the present conditions of weak investment activity, an increase in interest rates was undesirable. They were monitoring the situation closely and indicated that additional measures would be taken if necessary.

(2) Public sector policies

The original 1984 budget, approved in December 1983, forecast a reduction in the fiscal deficit of 3.5 percent of GDP to about 10 percent of GDP (7 percent after grants). Tax measures introduced with the budget included a temporary 1 percent rehabilitation levy on wages; a 10 percent rehabilitation surcharge on corporate income; large increases in BTT rates on nonessential goods; upward adjustment in specific excise duties; and the imposition of import duties on government imports. On the other hand, the level of personal income tax exemption was raised and the general BTT rate on retail trade was reduced. On a net basis, these measures were estimated to yield additional revenue equivalent to about 1 percent of GDP. Total expenditure was projected to decline by about 3 percentage points of GDP in the original budget, mainly because of a reduction forecast in capital outlays.

Recognizing that fiscal policy needed to be tightened to ensure achievement of the inflation and balance of payments targets, the authorities took additional measures in early 1984. Since the upsurge in world tea prices has substantially improved profit margins in the plantation sector, tea export taxes were raised in order to skim off the tea windfall gains. The authorities also reduced the extent of the wage indexation scheme for government employees, 1/ and undertook an expenditure pruning exercise. At the same time, however, some additional expenditures not foreseen in the original budget were added. Overall, the revised official budget estimates forecast a reduction in the deficit to about 9 percent of GDP (6 percent after grants). The revised estimates envisage a repayment of Rs 1.8 billion (1.3 percent of GDP) by the Government to the domestic banking system and a sharp decline in the borrowing from domestic nonbank sources. Consequently, the bulk of the deficit is expected to be financed from external sources, mostly foreign grants and concessional aid.

The staff team welcomed the additional measures but also noted that, if no further measures were taken to tighten credit expansion to the private sector, the budget, in order to achieve the inflation and balance of payments targets, might have to contribute more importantly toward a moderation of domestic demand through a higher repayment to the

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1/ Bachelors and each member of married couples both working for the Government will receive only half of the cost of living adjustment.

domestic banking system than presently envisaged. An additional measure that could be taken would be a restructuring of the tea export tax to make it progressive. 1/ Regarding the medium-term objective of strengthening domestic resource mobilization, the staff noted that the rehabilitation levy and surcharge were only temporary measures, while some of the other measures introduced in 1984, i.e., the increase in the tax exemption level and the reduction in the BTT on trade, actually contribute to a further weakening of tax buoyancy.

Public enterprises play a dominant role in the economy of Sri Lanka. In the past, many of them incurred large operating losses because of lack of price flexibility, high production costs, inadequate investment decisions, and poor management. The financial position of public corporations improved in 1983, largely as a result of higher revenues of the state plantation sector and of the Petroleum Corporation following adjustments in the prices of petroleum products. However, some enterprises are still running operating losses and many of them are characterized by overstaffing, undercapitalization, and a lack of timely information on their financial operations. The Government, in February 1984, set up a commission which is to make recommendations on ways and means of tightening financial discipline and improving the financial reporting system of public enterprises.

In April 1984, state plantations granted a 40 percent increase in workers' wages. While some adjustment was needed to improve incentives, the staff expressed concern about the impact of this sharp increase in wages on profit margins in the tea sector, should tea prices fall significantly. The authorities explained that they were considering the introduction of a salary scheme for plantation workers that would be partially tied to developments in international commodity prices.

(3) Exchange rate policy

Given the improved balance of payments situation, the authorities are satisfied with the flexible exchange rate policy adopted in 1983. They continue to monitor the situation closely and would use a more active exchange rate policy if the balance of payments situation warranted. The staff noted that since the depreciation of the rupee and unification of the exchange rate in November 1977, Sri Lanka has suffered a continuous loss of competitiveness, as successive nominal devaluations of the rupee have not been sufficient to correct the higher inflation in Sri Lanka than abroad. The more flexible exchange rate policy followed since mid-1983 has only slowed the deterioration. While there have been other impediments to the growth of exports, such as an effective protection policy that encouraged import substitution at the expense of export activity, the erosion of competitiveness has led to a

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1/ The present ad valorem export tax rate falls from 50 to 40 percent above Rs 55 per kg. In May, Sri Lanka's auction price for tea was Rs 62 per kg. on average.

decline in profit margins and contributed to the slow growth of exports. The breathing room provided by the high commodity prices has, therefore, not fundamentally altered the need for an active exchange rate policy. Since nontraditional exports have not benefited from the same increase in world prices as traditional exports have, the current situation of high commodity prices should not mask the need for a strengthening of competitiveness.

In March 1984, the authorities decided that for exporters to benefit from the concessional rediscounting facility, they had to sell forward the export proceeds. This action was taken in order to discourage speculation against the rupee and thereby speed up the repatriation of export proceeds. At the same time, they limited the demand for foreign exchange in the forward market for essential imports only. The staff noted that this change in regulations reduced the forward exchange rate and penalized exporters while it benefited certain importers. Since the last Article IV consultation, there have been no other significant changes in Sri Lanka's exchange system. 1/

(4) Structural issues

The 1983/84 stand-by arrangement included commitments to implement structural reforms in the areas of plantations, public investment program, taxation, and effective protection. Progress has been made in plantations and the investment program, but efforts in the two other areas have been limited so far.

On the basis of recommendations made by a management consulting firm, a performance-related incentive scheme was introduced for workers in the plantation sector in early 1984, and a similar scheme is scheduled to be introduced for managers. Reforms have also been introduced in the accounting system. In cooperation with the IBRD, the authorities have defined and adopted a medium-term investment program (MTIP) aimed at rehabilitating the plantation sector. The MTIP is designed essentially to increase yields on existing plantations through a series of measures including infilling, uprooting, and improving infrastructure and the use of inputs. The total cost of the MTIP is estimated at $200 million and is expected to be financed in part by foreign aid. The Bank staff is satisfied with the progress made so far in the plantation sector, and an IBRD loan in support of the rehabilitation program is under consideration.

Given the need to scale down and reorient the overall public investment program, the Government adopted a set of investment guidelines in early 1984. These guidelines specify that projects which the private sector is better equipped to handle should not be undertaken by the Government; that feasibility studies must be made for each project

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1/ See 1984 Annual Report on Exchange Arrangements and Restrictions.

before it will be considered by the Committee of Development Secretaries; and that only projects which satisfy approved criteria will be included in the investment program. Priority will be accorded to quick-yielding, production-oriented projects which would contribute to improving the balance of payments and satisfying essential infrastructure needs. In order to ensure proper maintenance of existing assets, the Government has decided to identify for each project prospective expenditures for operation and maintenance and to include them explicitly in the budget provisions. The view of the IBRD staff is that these guidelines are appropriate, but it has pointed out that several of the new projects added to the 1984 budget did not conform with the new guidelines.

A major weakness of the tax system is that it relies heavily on international trade-related taxes and lacks the necessary buoyancy to keep pace with the growth in GDP. As a result, the tax/GDP ratio had declined steadily in recent years, a deterioration which was only partially reversed in 1983. While the deterioration in the terms of trade has been a contributing factor, the fall in the ratio also reflects the erosion of the tax base, largely due to various tax exemptions, tax holidays, and weaknesses in the tax administration. The staff noted that the current favorable commodity prices should not distract from the need to make steady progress in strengthening the tax base. This is important so that when commodity prices weaken, the Government will have a broader tax base on which to rely.

The present tariff structure is characterized by wide differences in rates which do not reflect a clear and consistent set of policy objectives and which have introduced a general bias against exports in favor of inefficient import substitution. A Presidential Tariff Commission has reviewed and updated a 1981 IBRD-sponsored study of effective protection. The Commission endorsed the recommendations of the study and, in January 1984, tariff adjustments on about 60 items were introduced. While these adjustments are in the right direction, they represent largely a symbolic effort. The authorities explained that further significant action is likely to be taken in the second half of the year when the latest updating of the study is completed.

3. Statistical issues

The coverage and timeliness of Sri Lanka's statistics are, by and large, satisfactory. There are, however, two important areas where improvements need to be made. First, other financial institutions, particularly the National Savings Bank (NSB) which has been a captive source of government finance, have not, in the past, provided timely statistics on their assets and liabilities and, as a result, their financial operations could not be monitored closely. Second, the statistics reported for the FCBUs did not include a breakdown by loan maturities of their lending operations to residents. The authorities indicated that the reporting of statistics by the NSB is being improved, which should soon permit the monthly compilation of these statistics. Regarding FCBU statistics, a monitoring system of loans by maturity was set up in early 1984.

V. Staff Appraisal

The liberalization in 1977-78 of an economy that had previously been hampered by numerous administrative controls and distortions was a clear success in injecting vigor into the Sri Lanka economy, boosting production, reducing unemployment, and raising per capita incomes. The maintenance since then of an open and liberalized economy in the face of the sharply worsened world economic environment must also be regarded as a success. The projects undertaken under the Mahaweli program are being completed on schedule and they will contribute significantly toward increasing agricultural and domestic energy output.

However, the relatively high growth of the economy and the strengthening of its infrastructure were partly achieved at the cost of sharply increased external debt, as the Government was unable to improve the mobilization of domestic resources. At the same time, the increased reliance on foreign borrowing has not yielded corresponding gains in exports to service the associated growth in external debt. As a result, Sri Lanka is now faced with a sharp rise in its external debt service burden. This, together with an expected leveling-off of foreign aid inflows as the Mahaweli-related aid is phased out, will require a steady reduction in the external current account deficit during the coming years.

The authorities recognize the need for adjustment and plan to achieve it by scaling down and reorienting the public investment program to more directly productive areas and by following policies that will increase the domestic savings effort. Given the constraints in the medium term on the growth of output of traditional exports, the adjustment will also have to come from a strong growth in nontraditional exports and efficient import substitution. Policies need to be geared toward these medium-term adjustment goals.

The 1983/84 stand-by arrangement was in support of an economic program which was to be an important step toward dealing with the fundamental situation. The principal macroeconomic objectives of the program were to reduce substantially the fiscal and external current account deficits and to contain the rate of inflation. The main policy instruments were increases in taxes, cutbacks in the public investment program, a tightening of the monetary policy stance, and flexible exchange rate management.

The mid-1983 ethnic disturbances have created a very difficult environment for the authorities to pursue their economic program. In addition to the destruction of physical assets and disruptions in economic activity, these disturbances and their consequences have absorbed the time and attention of government officials at the expense of other aspects of economic management. At the same time, Sri Lanka suffered a severe drought in 1983, which reduced considerably the production of certain export crops. Despite these setbacks, significant progress was made in reducing the fiscal and external deficits, but there were also deviations from the program in some important areas.

The most disappointing outcome was a sharp acceleration in the rate of inflation, as the authorities relaxed their credit policy vis-a-vis the private sector in the course of 1983, compounding the demand effect of the improvement in the terms of trade. The fiscal deficit was reduced as envisaged under the program, but recourse to domestic financing was larger than anticipated, as the Government undertook additional projects in the course of the year while there was a shortfall in aided project implementation. Despite the considerable improvement in the terms of trade, the reduction in the external current account deficit was less than targeted under the program, partly because of the drought-induced decline in tree crop production and a fall in tourism following the ethnic disturbances, but also because of the relaxation of domestic financial policies.

The current high international tea prices will help reduce the external current account deficit in 1984, but it is widely expected that these favorable prices will not prevail for long. Given the medium-term adjustment need, the current favorable commodity prices must not lead to an easing of financial policies and a relaxation of efforts in the implementation of structural reforms. Rather, as envisaged by the authorities, this period should be used to build up reserves to more comfortable levels and to reduce further the external short-term debt.

The staff supports the authorities' objective of bringing down the rate of inflation to below 10 percent by the end of 1984 and reducing the external current account deficit to about 8.5 percent of GDP. The staff believes, however, that in order for these objectives to be achieved, current policies must be strengthened. In particular, the Central Bank's rediscounting facilities should be tightened and interest rates paid on government paper should be raised to market levels. The staff welcomes the expenditure pruning exercise undertaken by the Government in early 1984 and hopes that these cuts will be effectively implemented.

At the time of the approval of the stand-by arrangement, Executive Directors stressed the need for improving public sector savings by increasing taxes and strengthening the operations of public corporations. The 1984 budget did not introduce significant tax reform measures to expand the tax base. Comprehensive measures to that effect should be taken in the 1985 budget. Despite the significant improvement in 1983, the financial situation of public corporations remains an area of concern. While this is a complex matter, greater efforts should be made to devise measures to increase the efficiency of these corporations, to improve the reporting of their financial operations, and to monitor their investment and management decisions more closely.

A viable balance of payments position has eluded Sri Lanka largely because of slow export growth. During the last consultation discussions, Executive Directors emphasized the need to make major improvements in the plantation sector and to reduce the high protection offered by the present import tariff rates that has discouraged the creation of internationally competitive industries and introduced a bias against exports. The authorities have undertaken a comprehensive rehabilitation program in the plantation sector; if implemented effectively, this program would contribute importantly to a strengthening of export performance over the medium term. However, strong growth in nontraditional exports is also essential. In order to encourage these exports, a more active exchange rate policy is needed to improve competitiveness which has been eroded over the past several years. The current high commodity prices should not obscure the need for a strengthening of competitiveness for nontraditional exports which have not benefited from the same increase in prices as have traditional exports recently. Also, substantial progress in improving the system of effective protection should no longer be postponed.

Sri Lanka maintains an exchange system which is virtually free of restrictions on payments and transfers for current international transactions. As transitional arrangements under Article XIV, Section 2, Sri Lanka maintains limitations on the availability of foreign exchange for personal travel abroad.

In conclusion, Sri Lanka's economic achievements in terms of strengthening the country's economic base, reducing unemployment, and raising per capita incomes have been remarkable since the introduction of the 1977 economic reforms. The adjustment made in 1983 was also considerable, particularly considering the difficult environment in which economic measures had to be implemented. However, there were shortcomings in several areas, including in the implementation of certain structural reforms. It is hoped that despite the improved external economic conditions, the authorities will maintain prudence in resource management and will continue with vigor the longer-term structural reforms initiated in 1983/84. These reforms are essential for Sri Lanka to be able to carry out the external adjustment required in an environment of continuing growth and to strengthen the gains achieved in the area of social development.

It is recommended that the next Article IV consultation with Sri Lanka be held on the standard 12-month cycle.

VI. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision in concluding the 1984 Article XIV consultation with Sri Lanka in the light of the 1984 Article IV consultation with Sri Lanka conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Sri Lanka continues to maintain an exchange system which is virtually free of restrictions on payments and transfers for current international transactions. The exchange restrictions on personal travel allowances are maintained by Sri Lanka in accordance with Article XIV.

Table 8. Sri Lanka: Balance of Payments, 1980-84

	1980	1981	1982	1983 Program	1983 Prel.	1984 Off. Proj.
	(In millions of SDRs)					
A. Trade account	-758	-694	-890	-770	-804	-628
Exports, f.o.b.	818	903	918	960	987	1,244
Imports, c.i.f.	-1,576	-1,597	-1,808	-1,730	-1,791	-1,872
B. Services, net	40	5	-13	-40	-58	-61
Receipts	214	265	303	317	320	342
Payments	-174	-260	-316	-357	-378	-403
Of which: interests	(-45)	(-103)	(-116)	(-133)	(-162)	(-173)
C. Private transfers, net	105	172	240	260	256	267
D. Current account (A+B+C)	-613	-517	-663	-550	-606	-422
E. Official transfers	106	136	147	154	160	155
F. Nonmonetary capital, net	306	341	477	377	420	376
Private sector and public corporations, net	181	116	240	125	160	69
Central government, net	125	225	237	252	260	307
Disbursements	(201)	(267)	(304)	(325)	(337)	(373)
Amortization and progress payments	(-76)	(-42)	(-67)	(-73)	(-77)	(-66)
G. Errors and omissions	23	2	21	--	26	--
H. SDR allocation	12	12	--	--	--	--
I. Overall balance	-166	-26	-18	-19	--	109
J. Monetary movements						
Gross official reserves (- increase)	199	-96	-24	25	18	-67
Use of Fund credit, net	-23	136	-5	-10	-10	-2
Other items, net	-10	-14	47	4	-8	-40
Memorandum items:						
Official gross reserves at year-end	193	289	313	288	296	363
(in months of following year's imports)	(1.5)	(1.9)	(2.1)	(2.0)	(1.9)	(2.3)
	(In percent of GDP)					
Current account	-19.8	-13.8	-15.2	-12.0	-12.5	-8.3
Official transfers and nonmonetary capital 1/	14.5	13.1	14.8	11.6	12.5	10.4
Overall balance	-5.3	-0.7	-0.4	-0.4	—	2.1
Memorandum item:						
Current account deficit including grants	16.4	10.2	11.8	8.6	9.2	5.3

Source: Data provided by the Sri Lanka authorities.

1/ Includes SDR allocation and errors and omissions.

Table 9. Sri Lanka: Monetary Survey, 1980-84

End of Period	1980	1981	1982	1983	1984 March
	(In millions of rupees; end of period)				
Net foreign assets	1,080	685	-718	-150	1,872
Domestic credit	25,419	33,719	42,188	49,152	48,670
Public sector	13,223	17,377	21,913	22,024	20,338
Government	(9,100)	(12,889)	(17,236)	(17,639)	(15,662)
Public corporations	(4,123)	(4,488)	(4,677)	(4,385)	(4,676)
Private sector	12,196	16,342	20,275	27,128	28,332
Broad money	19,709	24,287	30,249	36,818	39,292
Money	(9,333)	(9,950)	(11,672)	(14,589)	(15,290)
Quasi-money	(10,376)	(14,337)	(18,577)	(22,229)	(24,001)
Other items, net	6,790	10,117	11,221	12,184	11,250
	(Annual percentage change)				
Domestic credit	81.0	32.7	25.1	16.5	9.0
Public sector	109.7	31.4	26.1	0.5	-7.1
Government	(207.2)	(41.6)	(33.7)	(2.3)	(-8.2)
Public corporations	(23.3)	(8.9)	(4.2)	(-6.2)	(-2.9)
Private sector	57.7	34.0	24.1	33.8	24.5
Broad money	31.8	23.2	24.5	21.7	20.4
Money	(22.1)	(6.6)	(17.3)	(25.0)	(18.8)
Quasi-money	(41.9)	(38.2)	(29.6)	(19.7)	(21.5)

Source: Data provided by the Central Bank of Ceylon.

Table 10. Sri Lanka: Central Government Operations, 1982-84

	1982	1983 Program	1983 Actual	1984 Budget	1984 Revised
		(In millions of Sri Lanka rupees)			
Revenue	16,610	22,700	23,763	28,898	31,224
Taxes	15,420	19,950	20,721	24,978	26,973
Nontax revenue	1,190	1,250	1,542	2,200	2,601
Central bank profits	—	1,500	1,500	1,700	1,650
Expenditure	33,914	39,000	40,081	43,073	43,638
Current	18,907	22,900	22,700	26,300	25,432
Advance Accounts	-879	600	1,120	300	900
Capital	15,886	15,500	16,261	16,473	17,306
Government deficit, before grants	-17,304	-16,300	-16,318	-14,175	-12,414
(excluding Central Bank profits)	(-17,304)	(-17,800)	(-17,818)	(-15,875)	(-14,064)
Government deficit, after grants	-13,928	-12,400	-12,881	-10,025	-8,264
(excluding Central Bank profits)	-13,928	-13,900	-14,381	-11,725	-9,914
Financing	17,304	16,300	16,318	14,175	12,414
Foreign financing	8,121	11,950	9,750	10,653	10,599
Grants	3,376	3,900	3,437	4,150	4,150
Foreign borrowing, net	4,745	8,050	6,313	6,503	6,449
of which: commercial borrowing	(1,225)	(1,750)	(1,365)	(900)	(1,365)
Domestic financing	9,183	4,350	6,568	3,522	1,815
banking system	3,675	500	473	681	-1,826
other	5,508	3,850	6,095	2,841	3,641
		(As percent of GDP)			
Revenue	16.6	18.9	19.4	20.6	22.3
of which taxes	(15.4)	(16.6)	(16.9)	(17.8)	(19.3)
Expenditure	33.8	32.5	32.8	30.8	31.2
Current (including adv. acc.)	18.0	19.6	19.5	19.0	18.8
Capital	15.8	12.9	13.3	11.8	12.4
Deficit before grants	-17.2	-13.6	-13.4	-10.1	-8.9
(excluding Central Bank profits)	(-17.2)	(-14.8)	(-14.6)	(-11.3)	(-10.1)
Deficit after grants	-13.8	-10.4	-10.6	-7.2	-5.9
(excluding Central Bank profits)	(-13.8)	(-11.6)	(-11.8)	(-8.4)	(-7.1)
Domestic borrowing	9.1	3.7	5.4	2.5	1.3
of which from banking system	(3.7)	(0.4)	(0.4)	(0.5)	(-1.3)
Memorandum item:					
GDP in billions of Sri Lanka rupees	100.3	120.0	122.3	140.0	140.0

Source: Data provided by the Sri Lanka authorities.

Table 11. Sri Lanka: National Accounts at 1978 Prices, 1979-83

	1979	1980	1981	1982	1983
	(Percentage contribution to GDP growth) 1/				
GDP	6.3	5.8	5.8	5.1	4.9
Consumption	10.0	7.0	7.0	3.9	5.5
Fixed investment	4.8	4.8	0.7	0.5	0.4
Government	(1.3)	(0.4)	(-1.0)	(-0.2)	(-0.2)
Private sector 2/	(3.5)	(4.4)	(1.7)	(0.7)	(0.5)
Stocks	0.2	1.0	-1.0	-0.1	-0.2
Total domestic demand	15.0	12.8	6.7	4.3	5.7
External balance	-8.8	-7.0	-0.9	0.8	-0.7
Exports	(0.3)	(-0.7)	(0.9)	(1.8)	(0.1)
Imports	(9.1)	(6.3)	(1.8)	(1.0)	(0.8)
	(Percentage change over previous year)				
Consumption	11.8	7.9	7.7	4.2	6.0
Fixed investment	24.0	20.4	2.6	2.0	1.5
Government	(18.0)	(4.8)	(-12.5)	(-2.7)	(-2.5)
Private sector	(27.4)	(28.5)	(9.0)	(3.6)	(2.8)
Exports of goods & services	1.0	-2.0	3.0	5.9	0.3
Imports of goods & services	23.0	13.8	3.6	2.1	1.8
GDP deflator	15.5	20.0	20.8	12.1	15.9
Sectoral growth					
Agriculture	2.0	3.1	6.9	2.6	5.1
Paddy	(1.4)	(11.9)	(3.6)	(-3.4)	(14.7)
Plantation crops	(3.9)	(-10.1)	(7.5)	(1.3)	(-4.3)
Manufacturing	4.6	0.8	5.2	4.8	0.8
Mining and quarrying	5.3	4.9	4.2	4.1	7.8
Construction	20.9	11.0	-3.0	-2.0	1.0
Services	7.8	8.0	6.4	7.0	6.0

Sources: Central Bank of Ceylon, Annual Report 1983; and data provided by authorities.

1/ Total may not add up to sum of components because of rounding.
2/ Includes public corporations.

Table 12. Sri Lanka: Medium-Term Outlook of Balance of Payments, 1983-1990

	Prel. 1983	1984	1985	1986	1987	1988	1989	1990
		Projection						
	(In millions of SDRs)							
Current account	-606	-422	-460	-420	-390	-355	-365	-390
Trade balance	-804	-628	-655	-610	-600	-585	-620	-675
Exports, f.o.b.	(987)	(1,244)	(1,255)	(1,340)	(1,460)	(1,605)	(1,765)	(1,945)
Imports, c.i.f.	(-1,791)	(-1,872)	(-1,910)	(-1,950)	(-2,060)	(-2,190)	(-2,385)	(-2,620)
Services	-58	-61	-80	-100	-95	-90	-80	-70
Receipts	(320)	(342)	(380)	(415)	(445)	(480)	(520)	(560)
Payments	(-378)	(-403)	(-460)	(-515)	(-540)	(-570)	(-600)	(-630)
Private transfers	256	267	275	290	305	320	335	355
Capital account	606	531	530	490	450	450	480	510
Official transfers	160	155	155	160	165	165	170	170
Nonmonetary capital	446	376	375	330	285	285	310	340
Overall balance	--	109	70	70	60	95	115	120
Gross official reserves (increase -)	18	-67	-34	-11	9	-23	-69	-88
Use of Fund credit	-10	-2	-36	-59	-69	-72	-46	-32
Other, net	-8	-40	--	--	--	--	--	--
	(As percent of GDP)							
Current account	-12.5	-8.3	-8.4	-7.0	-6.0	-5.1	-4.8	-4.8
Trade balance	-16.5	-12.3	-11.9	-10.2	-9.3	-8.4	-8.2	-8.3
Exports, f.o.b.	(20.3)	(24.5)	(22.8)	(22.4)	(22.6)	(23.0)	(23.4)	(23.8)
Imports, c.i.f.	(-36.8)	(-36.8)	(-34.7)	(-32.6)	(-31.9)	(-31.4)	(-31.6)	(-32.1)
Services and private transfers, net	4.1	4.0	3.5	3.2	3.3	3.3	3.4	3.5
Capital account	12.5	10.4	9.6	8.2	7.0	6.5	6.4	6.3
Official transfers	3.3	3.0	2.8	2.7	2.6	2.4	2.3	2.1
Nonmonetary capital	9.2	7.4	6.8	5.5	4.4	4.1	4.1	4.2
Overall balance	--	2.1	1.2	1.2	1.0	1.4	1.6	1.5
Gross official reserves (increase -)	0.4	-1.3	-0.6	-0.2	0.1	-0.3	-0.9	-1.1
Use of Fund credit	-0.2	--	-0.6	-1.0	-1.1	-1.1	-0.6	-0.4
Other	-0.2	-0.8	--	--	--	--	--	--
Memorandum items:								
Gross official reserves (millions of SDRs)	296	363	397	408	399	422	491	579
In months of imports	1.9	2.3	2.4	2.4	2.2	2.1	2.2	2.4

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

Table 13. Sri Lanka: Medium-Term Projection of Nonmonetary Capital Inflows and External Debt, 1983-1990

	Prel. 1983	Projection 1984	1985	1986	1987	1988	1989	1990
	(Millions of SDRs)							
Loan disbursements, net	385	340	340	295	245	245	265	290
Concessional borrowing, gross	256	250	290	290	300	310	320	340
Commercial borrowing, gross	241	200	180	170	170	180	190	200
Amortization	-112	-110	-130	-165	-225	-245	-245	-250
Direct investment	35	36	35	35	40	40	45	50
Total net capital inflows	420	376	375	330	285	285	310	340
Outstanding external debt (year-end)	2,805	3,143	3,447	3,683	3,859	4,032	4,251	4,509
Of which: Fund credit	(331)	(329)	(293)	(234)	(165)	(93)	(47)	(15)
Debt service payments	287	304	372	444	513	540	521	523
Of which:								
Interest payments	(162)	(172)	(207)	(219)	(221)	(225)	(231)	(242)
Fund repurchases	(46)	(22)	(36)	(59)	(69)	(72)	(46)	(32)
	(As percent of GDP)							
Total net capital inflows	8.6	7.4	6.8	5.5	4.4	4.1	4.1	4.2
Of which:								
Concessional borrowing, gross	5.3	4.9	5.3	4.9	4.7	4.4	4.2	4.2
Commercial borrowing, gross	5.0	3.9	3.3	2.9	2.6	2.6	2.5	2.5
Amortization	-2.3	-2.2	-2.4	-2.8	-3.5	-3.5	-3.2	-3.1
Outstanding external debt	57.7	61.8	62.7	61.8	59.8	57.9	56.4	55.3
(Excluding Fund credit)	(50.9)	(55.3)	(57.4)	(57.9)	(57.2)	(56.6)	(55.8)	(55.1)
Memorandum item:								
Nominal GDP (millions of SDRs)	4,862	5,084	5,500	5,960	6,450	6,970	7,540	8,160

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

Sri Lanka - Fund Relations
(As of May 31, 1984)

I. Membership Status

(a) Date of membership: August 29, 1950
(b) Status: Article XIV

A. Financial Relations

II. General Department

(a) Quota: SDR 223.1 million.
(b) Total Fund holdings of Sri Lanka rupees: SDR 564.9 million (253.2 percent of quota)
(c) Fund credit: SDR 347.7 million (155.9 percent of quota)

Of which:

	(SDR million)	(Percent of quota)
Buffer stock	5.8	2.6
Compensatory financing facility	38.3	17.2
Extended fund facility	253.6	113.7
Credit tranche purchases		
Ordinary resources	32.8	14.7
Enlarged access resources	17.2	7.7

(d) Reserve tranche position: SDR 5.95 million.

III. Current Stand-By Arrangement and Special Facilities

(a) Current stand-by arrangement

(i) Duration: September 14, 1983-July 31, 1984
(ii) Amount: SDR 100 million (44.8 percent of new quota).
(iii) Utilization: SDR 50 million (of which SDR 10 million purchased in September 1983, SDR 20 million purchased in November 1983, and SDR 20 million purchased in January 1984).
(iv) Undrawn balance SDR 50 million.

Sri Lanka - Fund Relations (continued)

(b) Previous stand-by and extended arrangements during the past 10 years

1. April 16, 1974-April 16, 1975: Stand-by arrangement
   Amount: SDR 24.5 million; 94.9 percent of quota (only SDR 7.0 million was purchased).
2. November 22, 1977-November 22, 1978: Stand-by arrangement
   Amount: SDR 93.0 million; 94.9 percent of quota (full amount purchased).
3. January 1, 1979-December 31, 1981: Extended fund arrangement
   Amount: SDR 260.3 million; 218.7 percent of quota, of which: SDR 80 million purchased in 1979; SDR 30 million purchased in 1980; SDR 150.3 million purchased in 1981.

(c) Special facilities during the past two years

August 25, 1982: Compensatory financing facility
Amount: SDR 39.2 million (SDR 26.2 million was repurchased in January 1983 on account of overcompensation).
January 26, 1983: Buffer stock financing facility (rubber)
Amount: SDR 5.8 million

IV. SDR Department

(a) Net cumulative allocations: SDR 70.9 million
(b) Holdings: SDR 0.2 million, or 0.31 percent of net cumulative allocations.

V. Administered Accounts

(a) Trust Fund Loans
   (i) Disbursed: SDR 95.4 million
   (ii) Outstanding: SDR 90.0 million

B. Nonfinancial Relations

VI. Exchange Rate Arrangement: Managed floating

VII. Last Article IV Consultation and Stand-By Discussions

Last Article IV consultation: staff discussions were held in Colombo during July 5-20, 1983; the Executive Board discussed the staff report (EBS/83/166 and Supplement 1) on September 14, 1983.
Last stand-by review mission: November 19-December 2, 1983.

Sri Lanka - Fund Relations (concluded)

VIII. Technical Assistance

(a) CBD. Since March 1983, an expert has been assigned to advise the Central Bank on rural credit matters. In 1983, an expert was assigned to advise the Central Bank on money market matters, but his assignment was interrupted after only a few weeks because of illness. A new expert will soon be assigned to continue the task undertaken.

(b) BUR. A member of the Bureau of Statistics visited Colombo from January 17 to January 28, 1983 to review Sri Lanka's financial statistics and improve their currentness.

IX. Resident Representative

A resident representative has been stationed in Sri Lanka since October 1977. Mr. Mountford, the current resident representative, took up his assignment in Colombo in January 1983.

Relations with the IBRD

(In millions of U.S. dollars)

IBRD and IDA Lending 1/	Disbursed IBRD	Disbursed IDA	Disbursed Total	Undis- bursed
Agriculture	--	63.93	63.93	116.93
Industry	5.11	28.20	33.31	63.03
Irrigation	14.01	56.57	70.58	90.42
Power	72.87	21.59	94.46	60.33
Telecommunications	--	7.17	7.17	22.83
Transport	--	33.09	33.09	37.16
Social infrastructure	--	14.92	14.92	24.28
Program credit	--	15.00	15.00	--
Total	91.99	240.47	332.46	414.98
Payments	48.01	3.93	51.94	
Debt outstanding (including undisbursed)	115.63	631.82	747.45	
Commitments after December 1983	12.10	30.00	42.10	
IFC net commitment			19.13	
Latest economic mission	December 1983			
Aid Consultative Group	The last meeting was held on June 21, 1984 in Paris.			

Source: Data provided by the World Bank.

1/ As of end-December 1983.

Note: During fiscal year 1984, IDA committed a total of $55.0 million for projects in the areas of industrial development and irrigation, with IBRD committing $12.1 million in the area of irrigation. Upcoming in fiscal year 1985, the World Bank is tentatively expected to present for approval projects involving about $63.0 million in IDA assistance and about $50.8 million on Bank terms.

Sri Lanka - Statistical Issues

1. Coverage, Currentness, and Reporting of Data in IFS

		Latest Date in June 1984 IFS
Real Sector	- National Accounts	1982
	- Prices	February 1984
	- Production	n.a.
	- Employment	n.a.
	- Earnings	December 1983
Government Finance	- Deficit/Surplus	Q3 - 1983
	- Financing	Q3 - 1983
	- Debt	December 1983
Monetary Accounts	- Central Bank	March 1984
	- Deposit Money Banks	January 1984
	- Other Financial Institutions	January 1984
External Sector	- Merchandise Trade: Values	December 1983
	- Merchandise Trade: Prices	December 1983
	- Balance of Payments	Q4 - 1982
	- International Reserves	April 1984
	- Exchange Rates	April 1984

The reporting record of the IFS correspondent during the past year has been generally good.

2. Outstanding Statistical Issues

Monetary Accounts

The mission learned that arising from the recommendations of the report of the January 1983 technical assistance mission on money and banking statistics, several new tables would soon be published in the Central Bank's Bulletin. It was also learned that improvements in the frequency and coverage of data on other financial institutions are under way.

Merchandise Trade - Prices

New indices on total export and total import volume and unit values are being compiled with a base year of 1982 and should be available during the current year.