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ROOM C-120 04

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/124

10:00 a.m., August 8, 1984

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
	T. Ramtoolah, Temporary
	H. G. Schneider
B. de Maulde	
	C. A. Salinas, Temporary
	M. K. Bush
	D. C. Templeman, Temporary
	M. B. Chatah, Temporary
H. Fujino	
	J. Reddy, Temporary
R. K. Joyce	
	H. A. Arias, Temporary
G. Laske	
	G. Gomel, Temporary
R. N. Malhotra	A. S. Jayawardena
	S. El-Khouri, Temporary
	T. de Vries
	H.-S. Lee, Temporary
	A. A. Agah, Temporary
F. Sangare	S. M. Hassan, Temporary
	J. E. Rodriguez, Temporary
	E. Olsen
	T. A. Clark
	J. Bulloch, Temporary
	Wang E.

L. Van Houtven, Secretary
J. C. Corr, Assistant

Also Present

African Department: R. J. Bhatia, Deputy Director; L. M. Goreux, Deputy Director; E. L. Bornemann, E. R. Borensztein, F. d'A. Collings, I. Kapur. Asian Department: S. Kohsaka, L. Mendras, M. R. P. Salgado, G. Szapary. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; E. H. Brau, B. de Schaetzen. Fiscal Affairs Department: P. R. Rado. Legal Department: A. O. Liuksila, J. K. Oh. Middle Eastern Department: P. Chabrier, Deputy Director; S. Thayanithy. Research Department: C. Osler. Advisors to Executive Directors: W. Moerke, G. E. L. Nguyen, J.-C. Obame, D. I. S. Shaw, A. Steinberg, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, Chen J., N. U. Haque, L. Ionescu, H. Kobayashi, A. Koné, M. Lundsager, J. K. Orleans-Lindsay, Shao Z., S. Sornyanyontr.

1. ZAIRE - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the second review under the stand-by arrangement for Zaïre (EBS/84/147, 7/10/84; and Cor. 1, 7/19/84).

Mr. Tshishimbi made the following statement:

For over a year and a half, the Zaïrian authorities have been implementing with determination the adjustment program in support of which the Fund approved a stand-by arrangement in December 1983. All performance criteria for the end of March 1984 have been observed. In addition, the rate of inflation has been reduced significantly, and the interbank foreign exchange market is performing smoothly and efficiently. Substantial progress has been made toward a reduction of the budgetary and the balance of payments deficits.

The reduction of the budgetary deficit during the first quarter of 1984 was made possible by a more favorable than anticipated performance of revenue and restraint in expenditure. Despite the sharp and unanticipated increase of about 5 percent in interest payments on foreign debts, total expenditure for end-March 1984 was below the program target. The key expenditure categories, namely, personnel outlays, salary payments to primary and secondary school teachers, and outlays of the political institutions, were all below the program targets. Appropriations for other current expenditures and for investment in nonpriority projects were cut. Government revenue was estimated at 12 percent more than forecast for the period, reflecting the determined efforts of the authorities to boost collection of taxes on goods and services and on incomes and profits and to improve tax administration. Payments by GECAMINES, the principal mining company, amounted to slightly more than the target for the first quarter. Efforts to rehabilitate the customs agency, OFIDA, have been reinvigorated. The authorities are satisfied with their efforts to strengthen budgetary discipline. As a result of a comprehensive study of government employment, which is about to be completed, 20,000 names were removed from the government payroll at the end of May 1984. There has been a significant improvement in the operation of the accounts of the Treasury held with the central bank. Specifically, the Government has decided that as of June 1, 1984 the drawdowns on the treasury subaccounts, which have so far escaped the budgetary controls, would be subject to prior authorizations by the Ministry of Finance. Moreover, for 1985, these subaccounts will be consolidated with the budget. The authorities hope that this would help prevent the commitment of unbudgeted expenditures and contain the level of credit to Government within the ceilings set under the program.

Reflecting the commitment of the authorities to improve the financial operations of public enterprises and following the recommendations of the conference of heads of public enterprises held in January 1984, a World Bank study on the general performance of the parastatals is now under way. The first phase of this study is aimed at establishing performance contracts under which progress achieved by each public enterprise can be measured. It will also assess the impact of the parastatal sector on the government budget and the sector's overall capacity to self-finance a significant share of its investment expenditure. In the meantime, the authorities have, among other measures, curtailed the activities of the two enterprises most concerned, pending their reorganization. In recognition of the need to improve the operating budget of the enterprises in the oil and transportation sectors, the authorities have decided to make a further adjustment in the petroleum price structure to be reflected in the retail prices of the oil products. I may add that the liquidation in June 1984 of SOZACOM, the state-owned mineral marketing company, underlines the authorities' determination to take drastic measures to reform the public enterprise sector.

Developments in the area of money and credit show that the measures taken during the first four months of the year to limit credit expansion have contributed to a substantial reduction of liquidity and to an improvement in the operation of the interbank foreign exchange market. The increase in net domestic assets of the banking system during the first quarter of 1984 was 12 percent compared with the 16 percent allowed under the program. Credit to Government remained similarly below the ceiling, and the expansion of credit to the private sector was only 3 percentage points above the program target. A new money market, intended for the nonbanking community, was created in April 1984. Short-term treasury bills with maturity periods ranging from 28 to 91 days are offered at remunerative rates ranging from 40 to 45 percent. In order to broaden the base of the new market and make it more attractive, the authorities have decided to issue bearer paper instead of making simple entries in the books of the central bank as had been done in the past, and to lower the minimum denomination to Z 10,000 from Z 50,000. The reserve ratio of the commercial banks was raised from 15 percent to 18 percent at the end of April 1984; and in June 1984 the rediscount ceilings at the central bank were increased to encourage the commercial banks to finance more economic activity, particularly in the agricultural and industrial sectors. With Fund technical assistance, the Bank of Zaïre has improved its accounting practices and intends to establish a permanent internal audit to be supported with periodic external audits. The Bank of Zaïre has also decided to raise the rate of interest on credit to Government which constituted a burden on its operating accounts. It is in the light of the foregoing that the ceilings on net domestic assets of the banking system and the respective subceilings on credit to Government and to the private sector have been adjusted. In this connection, I should emphasize that my authorities will continue to ensure that credit expansion does not endanger the primary objectives of the program.

In the external sector, the Zaïrian authorities are still concerned about the continued decline in copper prices in the world markets. As the staff has suggested, these price developments have not been unrelated to the ongoing attempts in the United States to impose restrictions on copper imports. The sensitivity of the Zaïrian economy to these unfavorable trends in the world copper markets cannot be overemphasized. However, the overall export performance during the first quarter of 1984 was favorable. On account of a significant increase in earnings from exports of diamonds, cobalt, and coffee, and the increased repatriation of earnings through official channels, the external position showed an improvement. The exchange rate reform of September 1983 and the supporting fiscal and monetary measures have reduced substantially the scope of parallel market activities and stabilized the zaïre at about Z 35 per U.S. dollar for the first six months of 1984. In accordance with the Paris Club accord of December 1983, bilateral agreements have been concluded with all creditors but two. Negotiations with one of the two remaining countries are scheduled to take place within a few weeks. With regard to the other country, efforts are under way to establish communications and schedule negotiations. A tentative schedule of payments to banks of the London Club has been agreed upon for the period up to March 1985.

My authorities are encouraged by the results of the measures taken so far. They renew, therefore, their strong commitment to achieve the objectives of the 1984-85 program.

Mr. Schneider, speaking on behalf of Mr. de Groote, said that Zaïre's recovery had been remarkable. When the current program had first been discussed in the Executive Board (EBM/83/174 and EBM/83/175, 12/16/83), many Executive Directors had expressed doubt about Zaïre's determination and continuity of purpose in its implementation. At present, the program appeared to be one of the most successful among the group of countries that had suffered major losses because of lower prices for their exports. Political circumstances in Zaïre--in particular, the increase in internal stability, the competence and devotion of those to whom President Mobutu had delegated the top responsibilities in the economic field, and the impact of the improved supply of consumer goods on the population of the cities--had been conducive to that achievement.

The program continued to be successful because it aimed at correcting the two traditional weaknesses of the Zairian economy, namely, the public sector deficits and the artificiality of the exchange rate, Mr. Schneider continued. Tax collection had improved, and wage increases in the public sector had remained within the targets. Although debt service payments had increased, net bank credit to Government had remained well within the agreed ceilings. The absorption of all payments by the interbank foreign exchange market had led to the repatriation of the bulk of export earnings through established banking channels, bringing about, in turn, a marked increase in the bases for the taxation of exports and company profits. The banking system was now fully familiar with the functioning of the interbank market, so that the marginal changes registered in the exchange rate were seen for what they really were--normal corrections under a system of floating exchange rates; they were, therefore, no longer a cause for speculative action. The full liberalization of imports had greatly contributed to the stabilization of prices, while the freedom to transfer dividends had already led to an awakening of interest in new foreign investment possibilities. The recent signing of an agreement with the United States on the protection of private investments in Zaïre by that country was another important step in the same direction. In sum, confidence had been restored in Zaïre through the reintroduction of market-oriented mechanisms. For that reason, Zaïre's recovery provided another convincing example of the validity of the policies advocated by the Fund.

The proposed increase in net domestic assets of the banking system was especially welcome, Mr. Schneider said. During the two previous discussions on Zaïre's situation (EBM/83/174 and EBM/83/175, 12/16/83; and EBM/84/68, 4/30/84) his chair had pointed out that the success of the program would probably require a relaxation of the ceilings in order that internal demand could be adjusted to the improved supply conditions. The fact that the cost of living had increased by only 5 percent in the first half of 1984 clearly indicated a reduced risk of inflation. In light of the upward adjustment in the net domestic asset ceiling, he urged the staff to continue to monitor that critical variable closely so as to maintain, over time, an appropriate balance between the fight against inflation and the need to let consumption benefit from the improvement in supply. The decision by the Governor of the central bank to establish a permanent internal audit in the Bank of Zaïre supported by periodic external audits was also particularly encouraging. The Bank of Zaïre had always been the cornerstone of sound economic management in Zaïre and that decision would add to its prestige.

The situation in the public enterprises remained critical, Mr. Schneider considered. Short of an increase in tariffs, there was no way to stem the continuing financial deterioration of several of those enterprises, which had led to a surge in arrears. The World Bank could play a useful role in that respect. Indeed, the financial stabilization of public enterprises was the most important single issue the staff could address in future reviews of programs.

Zaïre had done remarkably well in scrupulously respecting its debt reimbursement commitments, Mr. Schneider remarked. Few countries had been able to achieve a debt repayment ratio of the equivalent of 40 percent of total government income, as Zaïre would do in 1984, and the rate would increase in 1985. In the following years, however, such a high ratio would not be compatible with the needed recovery of the economy. He hoped, therefore, that all creditors would recognize that Zaïre, having demonstrated the capacity to repay and entering into a new phase of recovery, could only continue in that direction if adequate debt relief was granted.

Commercial arrears and arrears arising from investment in public works continued to cause concern, Mr. Schneider suggested. While he understood that the repayment of those arrears had had to be delayed in order that Zaïre could respect the performance criteria, the time had come to plan for their gradual repayment. The negative effect of arrears on business confidence was perhaps particularly great, since some of the creditor enterprises had been forced to carry losses on their accounts because of the nonliquidation of their claims. The situation deserved immediate consideration. Finally, the implementation of the program supported by the Fund would undoubtedly lead to a recovery of income, which would be faster if the world prices for Zaïre's main exports were to recover during the present phase of adjustment.

Mr. de Maulde stated that the staff's analysis and Mr. Tshishimbi's statement indicated that the program was on track on the demand side, but that progress was needed on the supply side. He congratulated the Zaïrian authorities on the results that they had achieved in the fiscal area. Revenues for 1984 were expected to be somewhat higher than originally envisaged and, despite a slight increase in expenditures, the overall budget deficit was expected to be reduced to 0.6 percent of GDP, a level that many developed countries would find satisfactory. Furthermore, through technical assistance from the European Community, there could be an improvement in the collection of customs duties, beginning in 1985.

The supply of credit to the private sector had been tightened more than warranted by fiscal developments, Mr. de Maulde continued, with adverse consequences for the financing of the agricultural sector. He could accept, therefore, the revised credit ceilings proposed by the staff. The moderation in credit expansion had brought about an impressive decline in inflation despite the massive devaluation of the zaïre. The consumer price index had risen by only 5 percent between December 1983 and May 1984--less than 15 percent on an annual basis. Therefore, the staff's projection of a 35 percent increase in the consumer price index for 1984 as a whole could be pessimistic. He invited the staff to comment further on the question.

Another issue deserving further elaboration was interest rates on treasury bonds, Mr. de Maulde considered. The staff mentioned that those bonds had been issued at rates of renumeration ranging between 40 and 45 percent. Since the increase in the consumer price index on an annual basis was about 15 percent, the real interest rate would range between 25 and 30 percent, thereby placing a heavy burden on the Treasury, a point that he had mentioned during the previous review of the arrangement for Zaïre. Was it Fund policy to advocate such levels of real interest rates? Would the Fund advocate a similar approach in Latin American countries? What was the justification for such rates?

Commenting on the supply side of the program, Mr. de Maulde expressed dissatisfaction with the level of capital expenditures in the budget. Despite the small increase of Z 200 million in the investment budget, to which the staff had agreed, the level remained too low to provide for the local zaïre counterpart funds needed to implement all the projects financed with external assistance, which was especially worrisome when the opening up of the supply side of the economy should receive the highest priority. Insufficient funding could only delay the necessary supply response, and it would have been preferable to accept a slightly higher budget deficit rather than insufficient investment. Had the World Bank been consulted on the investment budget? If so, what was the Bank's view?

Further progress was needed in the area of public enterprises, Mr. de Maulde suggested. Although the authorities had recently taken some steps to improve the financial performance of certain enterprises, in many cases tariffs remained out of line with costs, and price increases would have to be implemented. The involvement of the World Bank was welcome and he hoped that its efforts would be beneficial. He also welcomed the liquidation of SOZACOM, a step that should rationalize the marketing of mining products. In sum, the next program with Zaïre would have to pay more attention to the need to rekindle economic growth. In that regard, the appointment of a Fund resident representative could prove useful in improving the analysis of the supply-side aspects of the recovery.

Mr. Joyce commented that Zaïre had made remarkable progress over the past six months toward correcting the imbalances in the economy. The authorities had not only implemented the adjustment program with vigor but had also been prepared to take additional measures to ensure that the program remained on track. That conclusion, which was the most important to emerge from the second review of the stand-by arrangement, demonstrated the commitment of the Government of Zaïre to adjustment, a commitment that had not always been as forcefully evident in the past. In particular, the commitment to tighter demand management and to reform of the exchange system during the past six months was to be commended.

His chair had been concerned with monetary policy at the time of the previous review because of the excess liquidity that had existed in the banking system, Mr. Joyce recalled. It was encouraging that the authorities had implemented the additional measures recommended by the staff to absorb that liquidity, thereby strengthening the interbank foreign exchange market and providing the proper incentives to hold domestic currency and to ensure foreign exchange stability. The additional measures that the authorities had taken to meet the fiscal targets of the program were also welcome, including the drastic revision of the 1984 budget after the first review of the program and the continued efforts to reinforce budgetary controls. In light of that tightening of the fiscal stance, he could support an increase in the target for the fiscal deficit by a marginal amount to 0.6 percent of GDP in 1984. The financial performance of the public enterprises continued to be a matter of concern because it had deteriorated further in the first part of 1984. The authorities were aware of the situation, and the action that they had taken thus far to curtail the enterprises' activities was encouraging. Implementation of the first phase of the World Bank study was also welcome. The efficiency of a number of public enterprises could be raised by exposing them to greater competition; alternatively, they could be disposed of. He recommended both courses of action to the authorities.

Commenting on the external sector, Mr. Joyce welcomed the authorities' pursuit of a flexible exchange rate policy, which had brought about the virtual disappearance of the parallel market. The staff had not considered that further analysis of the medium-term outlook for the balance of payments was necessary on the occasion of the present review, a judgment with which he agreed. However, such an analysis should be included on the occasion of the next review because it would be an important factor in determining the need for a follow-on program, as well as the structural adjustments that would be needed to ensure a viable balance of payments position in the future.

The authorities had taken some fundamental steps toward correcting the imbalances, Mr. Joyce stated, but the adjustment process had only begun, and the authorities would have to continue to implement additional structural measures for some time to come. Although their resolve was clear, it would be a mistake if they proceeded to define their development projects too quickly. Therefore, he welcomed the frequent close monitoring of the program, which had helped the authorities to take decisive early action to correct divergencies from the program targets. He recommended that similar procedures should be followed in other programs that could be characterized as high risk. He also welcomed the formal request for a Fund resident representative and he agreed with Mr. de Maulde's remarks on the topic. Mr. Tshishimbi had said that the authorities had been encouraged by the results of the measures taken thus far. It could be said that the whole of the international community should be encouraged by those results and by the commitment now evident in Zaïre. He hoped that both public and private financial institutions would, therefore, provide support for the adjustment program.

Ms. Bush stated that she agreed with the staff appraisal and supported the proposed decision. Although the revisions in the program targets for 1984 were disappointing, she accepted the staff's explanation for them. Good efforts were being made in several areas, including the budget, foreign exchange market reform, monetary growth restraint, price decontrol, and interest rate adjustment. The reduction in the rate of inflation during the first five months of 1984 was especially welcome. In addition, the flexible exchange rate policy appeared to be having the desired impact, as evidenced by the significant reduction in transactions conducted in the parallel market and the increase in the repatriation of export earnings and transactions in invisibles in 1984.

Efforts to reduce subsidies in the public sector further and to control government expenditure better should continue, Ms. Bush remarked. One unfavorable outcome in 1984 was the deterioration of the financial condition of the public enterprises, including the accumulation of payments arrears owing to the slow adjustment of their tariffs to reflect rising costs. She urged the timely completion of the World Bank's report on the parastatal sector and she hoped that it would lead to appropriate pricing and to increased efficiency. She supported, in particular, the plan to initiate widespread auditing so as to increase the transparency of the government accounts. As a creditor, the U.S. Government was concerned about the degree of clarity in the accounts, because it affected her authorities' programs as well as the perceptions of potential foreign investors.

Commenting on monetary policy, Ms. Bush said she supported the efforts to soak up excess liquidity in the economy, but she feared that the tightness in credit to the private sector might already have adversely affected the production of food crops and cotton. She agreed, therefore, that there was a need to increase that credit target for 1984. However, the unavailability of credit for small-scale operations underscored the need for further increases in deposit interest rates and sustained decreases in inflation in order to generate additional savings. Her concerns about private savings and investment related specifically to the medium-term outlook. In light of the low rate of growth of GDP since the mid-1970s, it would be appropriate to devote more attention to stimulating growth, given that recent liberalization measures had freed the Government from some of its former involvement in short-term economic regulation. Growth could most effectively be generated by the private sector. She strongly urged additional progress in the deregulation and privatization of the economy, because such restructuring would make Zaïre a more attractive place for foreign credit and investment.

Although she could accept the revisions in the targets for 1984, an effort should be made to establish with care the performance criteria for the full year, if another stand-by arrangement were planned for 1985, Ms. Bush concluded. To improve the authorities' monitoring ability, she urged approval by the Fund of the requests for technical assistance from the Central Banking Department and for a resident representative.

Mr. Sangare observed that recent developments in Zaïre's economy had been favorable: the inflation rate had dropped sharply in 1984, all the quantitative performance criteria had been met, and the exchange rate and the balance of payments prospects had improved considerably. The measures taken by the authorities, including unification of the exchange rate in February 1984, had led to a substantial decline in parallel market activities, a more stable rate for the zaïre, and improved functioning of foreign exchange markets, which currently involved the whole banking system and had become more reflective of underlying market forces. The authorities' intention to continue to support a flexible approach should help to improve on those achievements.

Despite increases in tariffs, Mr. Sangare continued, inflationary pressures had subsided considerably in recent months as a result of the restrictive monetary policy. All the credit ceilings had been observed and expansion of the money supply had been within the target. Furthermore, the establishment of a domestic money market was a matter of considerable interest. However, the implications of a 45 percent yield on treasury bills were worrying, particularly for the level of interest rates and the resulting impact on investment, production costs, and the price level; he invited the staff to comment.

The authorities' efforts to reduce fiscal imbalances were commendable, Mr. Sangare considered. Improved revenue performance and curtailment of expenditures had helped to keep budget deficits within the program target. Nevertheless, the position of the parastatals remained weak, and the impact of that weakness on the goverment budget could endanger the progress that had been made. Other measures could be taken by the authorities to address that problem, including increased prices and tariffs and improved financial control. He hoped that the study on parastatals initiated by the World Bank would also help to improve the financial performance of those enterprises and provide the Government with the guidelines necessary to implement its program of rehabilitation.

The external sector's position also appeared to have improved, Mr. Sangare observed. Despite a sharp decline in the price of copper--Zaïre's main export--the better than expected performance of other exports had helped to reduce the current account deficit. Zaïre's success in rescheduling its debt and the balance of payments assistance provided by donors had also contributed to the improvement in the country's position, and medium-term balance of payments prospects appeared favorable. He urged the authorities to persevere with their adjustment efforts.

Mr. Clark recalled that at the time of the first review under the stand-by arrangement, his chair had commended the Zaïrian authorities for the progress that they had made toward reducing imbalances in the economy, but had emphasized that the current position, as well as medium-term prospects, remained difficult. Those comments applied equally in the context of the present review. He welcomed the further measures taken by the authorities, especially in relation to the exchange market, the domestic financial market, the control of the public sector, and the substantial deceleration in inflation. On the other hand, a further weakening in the copper price was undoubtedly a matter of concern because of its implications for future export earnings. While the effect of that weakening had for the present been offset by higher earnings from other export commodities, the situation might not last. It remained essential, therefore, that the authorities stick closely to the programmed path of adjustment.

The authorities' response to the prospective overshooting on expenditure and the shortfall in revenue was welcome, Mr. Clark continued. The revised budget deficit projected for 1984 remained a small proportion of GDP. He also welcomed the measures to bring treasury subaccounts under control and the authorities' resolve to tackle the problems of the parastatal enterprises. Nevertheless, no comprehensive and reliable data seemed to be available on the parastatals. The staff referred again to the World Bank study, but it did not make clear when the results would be obtainable. He invited the staff to comment on that point. On page 9 of EBS/84/147, the staff referred to a revaluation tax on corporate fixed assets. Did that tax apply to all revaluations, including those reflecting general inflation, and, if so, what effect would it have on the incentive to invest? Furthermore, with regard to the staff's comments concerning the rate of charge on central bank advances to the Treasury, it was surprising that the question had not been addressed in the course of the original program negotiations.

Commenting on monetary policy, Mr. Clark noted that both credit expansion and the increase in the monetary aggregates had been substantially less than envisaged under the program. He commended the authorities for the steps that they had taken to strengthen the structure of the financial market, in particular, the development of an expanded range of treasury instruments, and the move to establish positive real rates of remuneration on bank deposits. He looked forward to the staff's comments on the question raised by Mr. de Maulde as to whether real interest rates on some government instruments might not be unrealistically high at present.

The further liberalization of the exchange market regime was encouraging, Mr. Clark remarked, as was the decline in the exchange rate premium in the parallel market to a level roughly comparable with transaction costs in the official market. The reintegration of the parallel market into the formal sector should bring a number of benefits, directly by establishing appropriate relative prices and indirectly by providing a wider base for the application of tax and other policies. However, the overall external prospects remained difficult and substantial debt relief would be required well into the future. The unfavorable external position had been exacerbated by the renewed weakness of the copper price; the staff's assumption of an average price of $0.64 a pound in 1984 might prove optimistic. The staff stated that the revision of the medium-term balance of payments outlook did not appear warranted; however, he had suggested at the time of the first review of the arrangement that it would be helpful to provide alternative scenarios based on different paths for that key export price. In view of the latest movements in the copper market, he believed even more strongly that such sensitivity analysis would be valuable.

What was the objective of the requirement that importers should make advance deposits with the banks? Mr. Clark inquired. Furthermore, what was the status of arrears to non-Paris Club members at present? In sum, the period since the first review had seen a number of encouraging developments, for which the Zaïrian authorities were to be commended. Their request for a resident representative should help to ensure that progress was maintained. However, there was a long way to go, and, even in the present somewhat improved world economic environment, there was little or no room for slippage.

Mr. de Vries said that there had been a remarkable turnaround in the Zaïrian economy; it was encouraging that a well-designed adjustment program and determined implementation had produced relatively quick results to the benefit of the country and its population. He welcomed the staff's assessment that the program remained on track. A number of examples of the determination of the authorities were particularly striking: the removal of 20,000 names from the government payroll; the bringing under control of the subaccounts of the Treasury; and the sharp curtailment of the activities of some unprofitable public enterprises. It appeared that the authorities had become aware that economic development and the welfare of the people depended more on everyday activities, such as the provision of water, schooling, electricity, and roads, than on more flamboyant projects. The new emphasis and determination of the authorities in that regard were a positive development.

It would be important to maintain that commitment, Mr. de Vries continued, and the implementation of budgetary control would be central to the effort. One remaining weak spot was public enterprises. He agreed with Mr. Joyce that measures in that area were necessary and that they would have to involve price increases, managerial improvements through better auditing, the avoidance of direct government subsidies to the enterprises, and, if none of those approaches worked, the liquidation of unrpofitable enterprises rather than allowing them to continue as a burden on the Treasury. The World Bank's involvement in that regard was welcome, but it appeared to be getting under way at a slow pace. It was unfortunate that there was no representative from the Bank available to explain to Directors the Bank's objectives and why progress had been slow thus far. The problem of the enterprises was a central issue and the authorities would need all the advice and technical assistance available.

It was unacceptable that the central bank should register an operating deficit, Mr. de Vries stated. The measures that had been taken to eliminate that deficit were, therefore, welcome. The deficit had resulted from the levying of an unrealistically low interest rate on outstanding credit to the Government. He agreed with Mr. Schneider that the prestige of the Bank of Zaïre would increase further with the internal and external auditing arrangements that were being put in place.

A heavy debt burden remained, Mr. de Vries commented. The public portion of that debt was being addressed, but arrears continued to accumulate in the semipublic sphere. Those arrears should be reduced to restore confidence and thus enhance the conditions for debt rescheduling. Continued improvements in accounting and auditing practices in the economy would also be helpful, and in that context he welcomed the requests for a Fund resident representative as well as technical assistance from the Central Banking Department. He hoped that the authorities would build on their achievements and continue their impressive commitment to new policies aimed at guiding the economy toward sustainable economic development and growth.

Mr. Laske said that the staff's analysis provided an indication of the progress that had been made in Zaïre since the previous review under the stand-by arrangement. Economic developments appeared to have continued along favorable lines: the new interbank foreign exchange market, was operating smoothly and the program's objectives for the balance of payments and for inflation seemed to be within reach. Nevertheless, the authorities would continue to face difficult economic and financial challenges in the years ahead. Even if they pursued firm adjustment polices on both the demand management and supply sides, a viable balance of payments position might be achieved only by the end of the decade. That rather lengthy adjustment period was based on assumptions for the price of copper that could turn out to be optimistic; there was, thus, a degree of uncertainty about the external position.

Expected developments underlined the fact that the authorities' adjustment efforts would have to be maintained steadfastly, Mr. Laske continued. In some areas, they might have to be intensified further, particularly with regard to the public enterprises--as Mr. Joyce and Mr. de Vries had pointed out--which continued to be run less efficently than expected. The indications of further deterioration in the financial performance of those enterprises during the early part of 1984 were a cause for concern. Therefore, the authorities' decision to take a number of ad hoc measures to improve the enterprises' financial position was welcome. However, more comprehensive reform was urgently needed, including the possibility of closing down some of the enterprises. He strongly supported the World Bank's involvement in the reform process. As the staff indicated, however, substantial improvements in that sector could realistically be expected only over the medium term.

He welcomed the consolidation of the subaccounts of the Treasury into the budget, beginning in 1985, Mr. Laske remarked. The implementation of that decision should be monitored closely in future program reviews.

The progress that had been made in increasing the effectiveness and efficiency of monetary policy was also welcome, as was the establishment of a permanent committee to oversee the effectiveness and profitability of the central bank's operations, Mr. Laske commented. Less welcome, however, were the substantial operating deficits recorded by the Bank of Zaïre as the result of the extension of subsidized credit to the Government. The authorities' recent decision to eliminate the "hidden" subsidy by the Bank of Zaïre to the Treasury by increasing the interest rates on outstanding credit to the Government, although laudable, could have been taken much sooner. It would have been logical to increase the interest rate effective January 1, 1984, rather than July 1, 1984 as currently intended. Perhaps such a clear-cut solution might not have been practical. However, for 1985, he attached great importance to the adoption of such a practice from the beginning of the year, and he strongly supported the staff's recommendation that "the rate of interest on net credit to Government will have to be reviewed before the end of 1984 and any adjustment required will have to be implemented from the very beginning of next year."

While he could support the proposed decision, Mr. Laske said, he did so with the understanding that the changes in the quantitative performance criteria did not constitute a relaxation of the authorities' adjustment effort and that they would not, therefore, endanger the objectives of the program. Like other Directors, he welcomed the request for a Fund resident representative in Zaïre.

Mr. Wang remarked that he supported the proposed decision. It was heartening that Zaïre had made continued, significant progress in its adjustment performance under the current stand-by arrangement, which had been discussed by the Board three times in the short period of eight months. The rate of inflation had been reduced drastically, and substantial progress had been made toward the reduction of the budgetary and balance of payments deficits in spite of an unfavorable external environment. Furthermore, all performance criteria had been observed as of the end of March 1984. He commended the authorities for all those achievements.

Mr. Gomel recalled that, as his chair had noted on the occasion of the previous review, Zaïre's good policy performance under the stand-by arrangement owed much to one important quality in the design of the program, namely, the emphasis on prior policy actions. Those actions had been particularly helpful in setting in motion a prompt adjustment process, rebuilding creditors' confidence, and resuming normal external finance flows.

He was satisfied with the generally favorable outlook for the country's domestic and external stabilization, Mr. Gomel continued. The situation appeared to have strengthened comfortably since the previous review. Fiscal discipline continued to be imperative, and it was encouraging that revenue collection had led to a stronger than anticipated outturn in 1984. However, revenue performance remained exceedingly dependent on indirect taxes, trade-based duties, and temporary benefits from currency depreciation. On the expenditure side, Zaïre was enjoying the initial positive effects of stricter budgetary controls and centralized public spending authority. In previous arrangements, control over expenditure had been an almost intractable source of serious slippages.

A much more disturbing picture was painted by the staff with regard to the public enterprises, particularly their financial performance, and more generally, the Government's stance on tariffs and public utility charges, Mr. Gomel commented. The authorities should consider whether it would be feasible and effective at the present juncture to establish an indexation mechanism that would link the periodic revision of tariffs to the current inflation rate.

The overhaul of the exchange and trade system had been far-reaching, Mr. Gomel considered, with impressive consequences for Zaïre's balance of payments position. Two areas remained unclear. The projections for public capital inflows, although revised downward since the previous review, continued to show a sizable increase over the 1983 figures. What confidence should be attached to those forecasts? Finally, did the staff have information on the prospect of reaching a satisfactory agreement on arrears to non-Paris Club creditors?

Mr. Malhotra said that he joined other speakers in congratulating the Zaïrian authorities on the progress made in implementing the program under the stand-by arrangement, particularly with regard to the fiscal and monetary areas and foreign exchange market developments. The introduction of improvements in government accounting and expenditure control systems was also welcome. However, those efforts represented only the beginning; the authorities should be encouraged to take further action in those areas to consolidate the progress already achieved.

The importance of improving the performance of the public sector enterprises had been rightly emphasized by other Directors, Mr. Malhotra continued. While setting appropriate prices for the products of many of those enterprises would be important, the problems were more deep-seated, involving project implementation and managerial efficiency. It was, therefore, appropriate that the World Bank should be studying the enterprises' investment policy in order to improve their overall performance. Although progress in that area had been slow thus far, perhaps it would be possible to persuade the Bank and the authorities to quicken the pace of public enterprise reform. Finally, he supported the staff's recommendations with regard to the modifications of the performance criteria.

The Deputy Director of the African Department noted that, while there had been some depreciation of the zaïre against the U.S. dollar from March to July 1984, the real effective rate had slightly appreciated. The staff would be examining the matter in detail with the authorities shortly. The suppression of the parallel market in foreign exchange had undoubtedly widened the tax base and had also increased the foreign exchange available to the central bank. It would be important to keep the matter under review because export earnings from diamonds and gold, which were significant, were extremely sensitive to any discrepancy between the official and the parallel market rates for foreign exchange.

The staff had been surprised that the rate of inflation had declined as rapidly as had occurred, the Deputy Director continued. While the rate of inflation for 1984 as a whole would probably turn out to be less than the staff's initial estimate of 40 percent, it remained unclear at present whether it would be as low as 15 percent. Setting the initial rate of interest on treasury bills at a high level had been intentional in order to restore confidence in public institutions. For the same reason, the maturity of the bonds had been quite short. Thus far, there had been no problems associated with repayment of the bonds and, indeed, their success could be considered remarkable. The paper was now becoming available, which would enable the authorities to sell bonds throughout Zaïre and thereby reduce interest rates in a wider market. The first sale of treasury bills with actual paper would be conducted in August. The interest rate on bills had already declined somewhat from its initial high level, and the authorities stood ready to make further adjustments in light of changing monetary conditions.

The investment budget had been cut substantially at the time of the previous review under the stand-by arrangement, the Deputy Director recalled. The staff had discussed the question with the staff of the World Bank and, following the latter's investigation in June, the staff had suggested an increase of Z 200 million in the investment budget for 1984 to cover the local currency counterpart of projects that were being financed by external sources. The World Bank staff believed that the investment budget was rather low given Zaïre's needs, particularly in the transportation sector. However, the 1984 budget of Z 1.2 billion for public investment did not include a number of projects financed directly by public enterprises, some of which borrowed directly from the World Bank or other institutions. The staff would shortly be reviewing the outlook for the 1985 public investment budget with the authorities. In general, the budget had been managed well, and there had been an increase in revenues, primarily through improved tax collection. Preliminary data from the authorities indicated that the net claims of the banking sector on the Government had been below the subceiling for 1984, which would provide some useful room for private sector investment.

Many Directors had expressed concern about the position of the public enterprises, the Deputy Director observed, and had commented on the time being taken for the World Bank to report on its analysis. The preliminary results of the Bank's study would be available by about the end of September, which would be shortly before the discussions for the 1985 Article IV consultation. While it would be useful if the World Bank could intensify its efforts, it would be unrealistic to expect rapid completion because reviewing the various public enterprises was a time-consuming task.

As for monetary policy, the Deputy Director commented that much of the success of the floating exchange rate system had been due to the series of monetary measures that had been implemented rapidly by the authorities. The 65 percent deposit required of importers was intended to reduce the exchange risk because at present letters of credit continued to be fully covered by the banks. The efforts to improve internal auditing in the Bank of Zaïre would be strengthened by the arrival in the near future of an expert to assist the Bank. One reason for the delay in tackling the problem of the "hidden" subsidy by the Bank of Zaïre to the Treasury was that the staff had not been sufficiently familiar with the operating budget of the Bank of Zaïre when the program had originally been set up. However, it would have been inappropriate to have increased the rate of interest to the Treasury retroactively because doing so could have affected fulfillment of the performance criteria for March 1984. Therefore, the staff had suggested that the interest rate be increased as of July 1, 1984 and that further adjustments be made from the beginning of 1985.

At present, bilateral debt rescheduling agreements had been signed with all but two creditor countries, and those two agreements would already have been signed if it had not been for delays that had been beyond the control of the Zaïrian authorities, the Deputy Director went on.

The authorities also had in place a program to reduce commercial arrears, which was proceeding according to schedule. Indeed, in the first quarter of 1984, the reduction had been slightly higher than programmed. Nevertheless, if the balance of payments position improved, the staff agreed with the view that commercial arrears should be reduced more rapidly, because such a reduction would be important in restoring confidence. Some companies had transferred dividends when it had become possible to do so on July 1, 1984, but others had preferred not to transfer all their dividends because of their liquidity problems. An informal agreement had been reached with members of the London Club. In addition, letters had been sent to creditors that were not members of the Paris Club nor the London Club, and some progress had already been made with a number of those creditors.

Several Directors had commented on the weakness of copper prices, the staff representative recalled. The present price of copper was slightly below $0.60 a pound, about the same level as in June 1984. If it remained at that level for the remainder of 1984, the average realized price would be slightly more than 3 cents below the staff's estimate, resulting in export earnings of about $35 million less than staff projections under the program. It was clear that the medium-term outlook for the balance of payments would be substantially influenced by developments in the price of copper; however, it was difficult to forecast the direction of copper prices with accuracy. A useful rule of thumb was that in Zaïre's case a movement of 1 cent a pound in the price of copper was equivalent to about $11 million, although Zaïre had the advantage that its export earnings did not depend entirely on copper. The floating of the exchange rate had permitted an expansion of the export base, particularly gold and diamonds, and work was under way to expand the gold mines. Agricultural production should also benefit from a more realistic exchange rate, which would perhaps permit a reduction in food imports. The staff would present the revised medium-term outlook at the time of the next review under the arrangement. At present, the outlook had not changed significantly since the previous review. However, it was clear that Zaïre would need to reschedule its debt in 1985 and that it would need a long grace period for repayment. Progress had already been made in reducing the current external deficit and, with rescheduling, further progress could be made in the next few years.

With regard to capital inflows, the Deputy Director of the African Department remarked, the large increase in 1984 relative to 1983 was due to the renewal of suppliers' credits, which had been halted pending the outcome of the Paris Club meeting; because Zaïre had been able to make regular monthly payments, it had become easier for the country to obtain such credit. As to the proposed revaluation tax on corporate fixed assets, it was intended to deal with the effects of the substantial change in the value of the zaïre. The staff would be looking in detail at the issue in the course of its forthcoming discussions with the authorities. Finally, in order to allow sufficient time for preparation of the staff report following its next mission, it would be preferable to amend paragraph 3(b) of the proposed decision to read: "...not later than end-November 1984."

Mr. de Vries inquired whether it would be possible to draw to the attention of the World Bank at an appropriate level the concerns expressed by Executive Directors with regard to the progress of the Bank's study of the public enterprises in Zaïre.

The Acting Chairman said that the staff would communicate those concerns to the staff of the World Bank, and he would raise the question with the Senior Vice President, Operations, of the Bank in the course of his regular discussions on matters relating to Fund-Bank cooperation.

Mr. Joyce suggested that the proposed decision would be clearer if in paragraph 3(b) the word "conducted" was replaced by the word "completed," so it read: "...which is to be completed not later than end-November 1984."

The Deputy Director of the African Department, responding to a question by Mr. Hassan, said that the interest rate on the first sale of treasury bills had been set at a high level to bolster confidence and because inflationary expectations and the external value of the currency had been high. The rate would be adjusted in light of changing monetary conditions. Although there was no doubt that the high interest rate had had an impact on the costs of various enterprises, it had played a strong role in persuading banks and other enterprises to hold zaïres rather than foreign currency. The improved yields had also persuaded some firms not to transfer their dividends out of Zaïre when it had become possible to do so in July, but to hold domestic currency to improve their liquidity position. There was a cost to the budget of such high rates, but it was expected to decline, while remaining positive in real terms, if inflation continued to be modest.

Mr. Malhotra noted that in Attachment IV to EBS/84/147 it was indicated that at the start of the program the increase in the GDP deflator had been 47 percent, the same amount as the increase in consumer prices. At the time of the first review both figures had been revised to 49 percent. However, the newly revised projections indicated that the GDP deflator was expected to be 90 percent in 1984, while consumer prices were expected to increase by 35 percent. He invited the staff to comment on the revised projections.

The Deputy Director of the African Department said that the GDP deflator took account of the increases in the prices of both tradable and nontradable goods. Because exports accounted for a large part of Zaïre's GDP and because the price in domestic currency of exports had increased considerably as a result of the depreciation, the GDP deflator had increased much more than the cost of living index. That point had not been fully reflected in the earlier projections.

Mr. Tshishimbi commented that a number of Directors had focused on the position of the public enterprises as a weak spot in the performance of the economy. His Zaïrian authorities were fully aware of the deficiencies of that sector, as indicated by their decision to close the company involved in the marketing of copper and diamonds, SOZACOM. The authorities had also placed a good deal of confidence in the technical assistance that the World Bank was providing. However, he shared the concerns of other Directors about the speed with which the World Bank was dealing with the problem. Moreover, similar delays had arisen in connection with the World Bank's activity in other countries in his constituency as well as in other member countries. The Bank's procedures were generally lengthy; it would be helpful if the issue could be raised in the context of Fund-Bank collaboration. Regarding the operation of the Bank of Zaïre, the authorities had again demonstrated their commitment to better economic performance by requesting technical assistance to help that important institution to improve its policy making functions.

With regard to the medium-term prospects, Mr. Tshishimbi continued, when an economy such as Zaïre's improved its performance and succeeded in re-establishing the confidence of the international as well as the national community, it was important that adjustment did not concentrate solely on the demand side. Increased attention would have to be given to the supply side soon. Real incomes had been declining for a number of years, and he hoped that the staff would pay more careful attention to that urgent problem in the course of its forthcoming discussions with the authorities. On external public debt, as the Deputy Director of the African Department had indicated, agreement had been reached with members of the London Club and payments were being made regularly. He was confident that payments would continue in line with the agreed tentative schedule and that further progress would be made on a specific timetable for payments to other creditors.

The Acting Chairman observed that there would be an opportunity for the Executive Board to discuss the general question of Fund-Bank cooperation in the near future. The staff was preparing two papers on the subject and they would be circulated shortly. It was hoped that the discussion could be scheduled for a date shortly after the Annual Meetings.

The Deputy Director of the African Department said that the Fund resident representative would join the next staff mission to Zaïre in August; he would settle in his post immediately after the Annual Meetings. His appointment would allow closer cooperation with the World Bank's representative in Zaïre, and careful study of the public enterprises.

Mr. Joyce remarked that the issue of delays in World Bank procedures had arisen in one of the countries in his constituency. He hoped that it would be discussed in the forthcoming papers on Fund-Bank cooperation. Perhaps it could also be raised directly with the management of the Bank.

The Executive Directors then took the following decision:

1. Zaïre has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Zaïre (EBS/83/257, Supplement 2, 12/22/83), and the letter of the President of Zaïre dated September 12, 1983, with annexed memorandum attached to the stand-by arrangement, in order to reach understandings subject to which Zaïre may make further purchases under the stand-by arrangement.

2. The letter of the President of Zaïre dated July 4, 1984, together with Table 1, shall be attached to the stand-by arrangement for Zaïre, and the letter of September 12, 1983 with annexed memorandum, supplemented by the letter of March 26, 1984, with Table 1, shall be read as supplemented by the letter of July 4, 1984, and Table 1.

3. Zaïre will not make purchases under the stand-by arrangement that would increase the Fund's holdings of Zaïre's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12 1/2 percent of quota

(a) during any period in which

(i) the ceilings on net domestic assets of the banking system at end-September and end-December 1984; or

(ii) the ceilings on net credit of the banking system to the Government at end-September and end-December 1984; or

(iii) the net cumulative reductions of commercial and invisible arrears through cash payments in foreign exchange by end-September and end-December 1984; or

(iv) the limits on new external borrowing, on a commitment basis, by the Government or against government guarantee through end-September and end-December 1984

specified in Table 1 attached to the letter of July 4, 1984 are not observed; or

(b) if the review with the Fund relating to the fourth purchase under the stand-by arrangement, which is to be completed not later than end-November 1984, has not taken place, or while the performance criteria adopted as a result of this review are not being observed.

4. Paragraph 4(c) of the stand-by arrangement for Zaïre (EBS/83/257, Supplement 2, 12/22/83), shall be amended to read as follows:

"(c) during the entire period of the stand-by arrangement, while Zaïre has any overdue financial obligations to the Fund, or if Zaïre...."

Decision No. 7779-(84/124), adopted
August 8, 1984

2. SRI LANKA - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Sri Lanka (SM/84/150, 6/29/84). They also had before them a report on recent economic developments in Sri Lanka (SM/84/173, 7/23/84) and an information notice on the real effective exchange rate of the Sri Lanka rupee (EBS/84/165, 8/6/84).

Mr. Jayawardena made the following statement:

My authorities are grateful to the Fund and the staff for the excellent and objective analysis of recent economic developments in Sri Lanka, as presented in the papers SM/84/150 and SM/84/173. My authorities are in broad agreement with the staff appraisal, and intend to persevere with policies aimed at stabilization of the economy, which were revived in 1983 (supported by a stand-by arrangement, June 1983-July 1984) and pursued despite the sharp improvement in the terms of trade and the balance of payments since the last quarter of 1983, and the intensification of problems relating to national security since mid-1983.

Sri Lanka's current adjustment needs and efforts have to be understood in the relevant domestic and world economic situation. After managing an increasingly centralized and controlled economy for nearly three decades, Sri Lanka made a dramatic about-turn in economic strategy in 1977, when it liberalized the economy and moved toward an open market economy. This reform was strongly supported by the Fund, the World Bank, and the international community, but was greatly hampered by the evolution of the world recession and a massive deterioration in Sri Lanka's terms of trade, which slowed the pace of adjustment. When the Board last discussed Sri Lanka's request for the stand-by arrangement, I mentioned that my authorities would be considering further adjustment measures after the elections of late 1982. While these measures were being worked out and implemented, leading to the stand-by arrangement (and a potential structural adjustment loan from the World Bank), escalation of terrorist activities led to ethnic disturbances in July 1983, which has compelled my authorities to devote highest priority to devising policies promoting greater peace and harmony and strengthening national security, a vital prerequisite for economic adjustment and growth. Unfortunately, these developments have slowed the planned adoption of adjustment measures, for which reason my authorities have decided not to avail themselves of the drawings during the second half of the stand-by arrangement. My authorities believe that, in the sensitive political atmosphere, adjustment should be undertaken with caution and circumspection, and with active political support, so that adverse reactions would not compel them to retract or retreat from their objectives.

The main achievement of the economic liberalization was the increase in real GDP by 6 percent a year on average between 1978 and 1983, which was double the rate achieved during 1970-77. Unemployment was halved from about 24 percent in the mid-1970s to about 12 percent in 1983. Agricultural output in the period 1978-83 grew at twice the previous rate. Sri Lanka has now reached the threshold of self-sufficiency in its staple food, rice. There has been a substantial expansion of nontraditional agricultural and industrial exports. Income from tourism has become buoyant and remittances from earnings by expatriates have expanded to become the second largest single income earner, after receipts for tea exports.

As shown in the staff papers, the policies that promoted a strong economic recovery also created imbalances in the economy. As the main thrust of the new policies was to reactivate a long-stifled private sector and encourage foreign private investment, the infrastructure in irrigation, energy, transport, communications, and urban development had to be improved considerably. For this, my authorities adopted a substantial public investment program, nearly doubling public investment as a percent of GDP, which was largely financed by highly concessional external resources. However, faced with five consecutive years of terms of trade deterioration (of about 30 percent), the balance of payments also continued to deteriorate. Government expenditures rose, as the huge foreign investment had to be matched with domestic resources. But revenue remained sluggish because of the terms of trade decline and the early incentives that had to be given to revive the private sector. Thus, inadequate domestic savings had to be supplemented with external commercial borrowing, which raised the debt service ratio to about 18 percent of current account receipts. The growing budgetary deficits and the long gestation nature of the public investment program, together with higher rates of inflation abroad at the outset, exerted pressure on prices, and inflation remained high at two-digit levels.

It may not be correct to characterize the external adjustment problem now facing Sri Lanka as one where increased reliance on foreign savings has not been accompanied by comparable gains in exports to service the associated increase in external debt. With the major public investment projects coming on stream later in 1984 and in 1985, energy and other import savings will be considerable. In view of its geographic location, Sri Lanka has been highly vulnerable to the vagaries of weather, and effective control over regular sources of water, which has been and will be the key to growth in agriculture, will be facilitated by the investments coming to maturity. As evidenced by the setback suffered by industry last year through power shortages, a healthy private sector development cannot be expected unless the necessary infrastructure is provided. The problem, therefore, appears to lie elsewhere. A small island economy with a limited domestic market, having gradually reached limits of import substitution, has now to adjust its sights to an era of economic growth based on a strong increase in exports. As evident in many newly emerging industrial countries in Asia, an export-led growth strategy cannot be merely willed into existence. Having created the necessary physical infrastructure, it would be necessary for Sri Lanka to provide the market incentives for export growth through open economic policies, a realistic exchange rate policy--which would make exports relatively more attractive vis-à-vis production for the domestic market--stable and noninflationary domestic conditions, and active promotion of export markets over a period of time. A prerequisite for such a transition in Sri Lanka would be the initial stabilization of the economy, restraint of inflationary tendencies, and the elimination of biases against exports. The initial stand-by arrangement in 1983/84 was conceived in such a framework of short-term stabilization.

Although interrupted halfway, the stand-by arrangement set in motion a series of policy measures that had a positive impact on adjustment in Sri Lanka. The external current account deficit declined by 2.5 percentage points of GDP to 12.5 percent in 1983, which was only slightly more than the target under the program of 12 percent. The overall payments position was in balance compared with deficits in previous years, a 15 percent improvement in terms of trade, which was in excess of the anticipated 11 percent improvement, having contributed to this evolution. Import growth in 1983 was substantially lower than in the previous year, while no growth was assumed under the program. The nominal effective exchange rate, which appreciated by 5 percent in 1982, declined by 10 percent in 1983, whereas the real effective exchange rate, as measured by the formula agreed with the Fund, depreciated by 2.5 percent in 1983 as against a depreciation of 2 percent in the previous year. Most significant, the agreed formula for exchange rate change enabled my authorities to come to terms with the principle that the rupee has to remain competitive in terms of relative inflation.

A substantial fiscal revenue raising effort was achieved in 1983 (an increase of 43 percent compared with 9 percent in 1982), and growth of budget expenditure was slowed down by rephasing of capital expenditure and further reduction of subsidies. As a result, the fiscal deficit was reduced from 13.8 percent of GDP in 1982 to 10.6 percent in 1983. Domestic credit expansion declined from 25 percent in 1982 to 17 percent in 1983, although the latter exceeded what was envisaged under the program. There was a sharp increase in private sector credit, partly due to a slight relaxation of monetary restraints in early 1983, but the policies were considerably tightened toward the end of the year and during 1984, following the strong terms of trade improvement. However, given the credit expansion, the impact of the rupee depreciation, and corrective price adjustments, inflation gathered momentum, necessitating corrective measures in 1984. In sum, there was a recognition of the need for strong adjustment, and reasonable progress was made in the fiscal and external fronts, whereas monetary restraints were reinforced in late 1983 and in 1984. That these achievements were made during a period of some uncertainty and political sensitivity, especially after the July 1983 civil disturbances, should not be underestimated.

The stand-by arrangement also anticipated the initiation of certain structural reforms in state-owned plantations, tariffs, public investment, and taxation. As detailed in the staff reports, major reforms in restoring incentives in the plantations were adopted in early 1984. Similarly, apart from the selective phasing out of the public investment program, investment guidelines have been adopted in the public sector. Priority has been assigned to quick-yielding projects which would have an early impact on the balance of payments. The need for maintenance of existing assets has also been emphasized. The World Bank considers these reforms appropriate. For the first time, certain tariff adjustments, based on effective protection, were adopted in early 1984. Although modest in extent, the adjustments are noteworthy and reflect some progress in the sense that the use of effective protection calculations has now been accepted as a principle in determining the tariff structure. A more substantial tariff reform is now being considered by my authorities. With regard to tax reforms, the long dependence of Sri Lanka on trade-related taxes could not be instantly corrected, especially because special incentives had to be given at the initial stages to revive the private sector and because the growth in incomes after the economic reforms was widespread. The abolition of overgenerous tax holidays and measures to improve tax administration now being implemented should contribute to widening the tax base and improving the yield through greater compliance.

As a further improvement in the terms of trade is anticipated in 1984, the external current account deficit is expected to decline further to about 8.3 percent of GDP, and a surplus in the overall balance of 2 percent of GDP is anticipated. This surplus could be used to build up reserves to more comfortable levels and to reduce commercial debt. In fact, the Central Bank has by now virtually repaid its commercial borrowings. At the same time, a further reduction in the fiscal deficit of 3.5 percent of GDP is likely to be realized, as a result of enhanced tax measures and further curtailment of expenditures. A sharp decline in borrowing from domestic nonbank sources and a repayment of bank borrowing of about 1 percent of GDP are also anticipated. The monetary restraint measures adopted in late 1983 and in 1984 reflect the determination of the authorities to maintain a noninflationary policy. It is noteworthy that the special issues of central bank securities have already mopped up nearly Rs 0.5 billion of excess liquidity, generated by the terms of trade improvement. Treasury bill rates have moved up. According to latest figures, inflation declined to about 18 percent in June and the target of bringing it below 10 percent by the end of the year should be achievable.

The 1984-88 Public Investment Program contemplates a further slowing down of capital expenditure and a reorientation of new expenditure to directly productive fields and the maintenance of existing infrastructure, representing an overall scaling down of the program by about 10 percent. Budgetary outlays as a ratio of GDP are expected to rise from 14 percent in 1984 to 16 percent in 1985 (for the completion of ongoing projects), but decline thereafter to about 10 percent in 1988. This would be consistent with the intention of not crowding out the private sector and of scaling down public investment to more manageable proportions.

My authorities broadly agree with the medium-term balance of payments outlook for 1984-90 presented on page 17 of SM/84/150. As the current terms of trade improvement is not likely to continue beyond 1984, and as a revival of traditional exports would necessarily involve a long gestation period, a modest growth in exports may be a reasonable assumption to make. The reduction in the external current account deficit from about 8 percent of GDP in 1984 to about 5 percent in the years 1988-90 appears to be viable, given the anticipated decline in external capital inflows from the current high levels. This would entail a rise in external debt service, as a ratio of current receipts, from 18 percent in 1983 to about 23 percent in 1987, a decline thereafter to about 18 percent by the end of the decade, and a reduction in commercial borrowing from 5 percent to 2 percent of GDP during the same period. While this scenario may be appropriate for medium-term external adjustment, my authorities are mindful of the need for additional measures to promote exports and economic growth.

Of course, the above scenario presumes the continuation of open economic policies, the adoption of appropriate adjustment measures, generation of increasing levels of domestic resources, and the continued support of the international community during the early stages of transition. In the past, my authorities have persevered with adjustment policies under most difficult circumstances, and they are determined not to abandon this path in the future, although the pace of adjustment may be influenced by evolving internal and external circumstances. My authorities are most grateful for the support and understanding shown by the Fund and the international community to Sri Lanka, and they look forward to continued cooperation and support in the future.

Extending his remarks, Mr. Jayawardena noted that recent data indicated that during the first six months of 1984 M-1 had increased by no more than 0.1 percent. Although M-2 had risen by about 6.8 percent, the increase was only half that recorded during the same period in 1983. The data could be interpreted as evidence of the success of the tightening of monetary policies that had taken place since the last quarter of 1983. On the other hand, the increase in the cost of living index in the first half of 1984 had been 9.7 percent, which could place that interpretation in doubt. The explanation seemed to be that it took time for a monetary policy to take effect; moreover, the increase in the cost of living index had been the result of short-term abnormal developments that had been rectified. It appeared that inflation was abating.

The balance of payments had shown a substantial improvement in 1984, Mr. Jayawardena continued. For instance, during the first half of the year, the current account deficit had declined sharply to SDR 148 million compared with SDR 250 million in the same period in 1983. As a result, his authorities expected that the buildup of reserves in 1984 could be higher than anticipated. Nevertheless the authorities' resolve to persevere with the short-term stabilization measures remained unchanged.

Mr. Fujino said that, although significant progress had been made in reducing the fiscal and external deficits despite difficult social conditions and a severe drought, there had also been less favorable developments in Sri Lanka in some other important areas since the economic program supported by the 1983/84 stand-by arrangement had been implemented. The higher than targeted credit expansion had led to the acceleration of the rate of inflation. Although the fiscal deficit had been reduced as envisaged under the program, the reduction in the external current account deficit had been less than targeted. Perhaps the most disappointing aspect was that Sri Lanka's right to purchase under the arrangement had been interrupted after the discussions with the Fund's review mission. In spite of the recent movement of commodity prices, which was expected to have a favorable impact on the external position, efforts toward implementing structural reforms should not be relaxed at present. He welcomed the view of the authorities that the present favorable period should be used to build up foreign exchange reserves and to reduce the external short-term debt further. However, he agreed with the staff that, in order for those objectives to be achieved, current policies would have to be strengthened.

The sharp increase in credit to the private sector during 1983, which had, inter alia, led to an upsurge in inflation, was a matter of concern, Mr. Fujino continued. He strongly supported the staff's view that efforts should be made to tighten the Central Bank's discounting facilities and to raise the interest rate paid on government paper to market levels. He welcomed the additional fiscal measures taken by the authorities in early 1984: the increase in tea export taxes and the reduction in the extent of wage indexation for government employees. Nevertheless, it was apparent that fiscal policy might have to play a more important role in order to achieve the inflation and balance of payments targets for 1984. Further measures should be taken to increase tax revenue and to strengthen the financial position of public corporations. He welcomed the initiative taken by the authorities in setting up a commission to make recommendations on ways of tightening the fiscal discipline of public enterprises.

In spite of recent favorable commodity prices, the importance of a steady reduction in the current account deficit for medium-term adjustment had to be emphasized, Mr. Fujino remarked. The staff noted that the current account deficit would have to be reduced to about 5 percent of GDP by the end of the 1980s in light of a projected decline in net capital inflows. He shared the staff's views that export performance would have to be improved much further to ensure adequate adjustment and that a more active exchange rate policy was needed to improve competitiveness.

Mr. de Vries observed that there had been a continuous improvement in the Sri Lanka economy since the major change in policy in 1977. It was encouraging that the effort had been sustained despite the circumstances that at times had inevitably slowed it, such as the election campaign and the social disturbances noted by the staff. In spite of those obstacles, adjustment had continued, particularly in 1983, although it appeared that it had not been sufficient. It was difficult to understand why the results were slow to come through. Perhaps, as Mr. Jayawardena had suggested, a number of the efforts had long gestation periods and the benefits of investments already undertaken would become evident in the next few years. Such an explanation would be encouraging because it would indicate that the situation was about to improve. It might also be the case, as Mr. Jayawardena had mentioned, that the limits of import substitution were being reached and that it would not be easy to find new export markets in a difficult world trade environment.

While such factors would certainly be relevant, Mr. de Vries continued, there were a number of steps that the authorities could take to speed up or to consolidate the adjustment effort. For example, as Directors had noted at the time of the approval of the stand-by arrangement (EBM/83/139, 9/14/83), the plantation sector was in need of sustained structural reform. Although measures had been taken in that area, they would need to be steadily maintained if they were to be effective. While results might not appear in the short term, traditional exports could be an important basis for the overall export drive. Furthermore, in the past, tariffs and other measures had discouraged the creation of internationally competitive enterprises that could provide new exports, which would be needed to supplement traditional exports. Increased international competitiveness would make a considerable contribution to the export prospects of Sri Lanka; in that regard, a more active exchange rate policy might produce results that had thus far eluded the authorities. A reduction in the public sector deficit could also help to improve the current account position, albeit indirectly.

Measures along the lines that he had suggested would not be easy for the authorities to take, Mr. de Vries observed, because of the political circumstances in the country. However, as Mr. Jayawardena had indicated, adjustment would have to take place in one way or another by the end of the decade; it would be better for it to come about through policies that produced additional exports and, thereby, additional growth and welfare, than in a more haphazard fashion. He hoped that the authorities would find the means to sustain their adjustment effort more effectively.

Mr. Templeman stated that the Sri Lanka authorities should be commended for the favorable economic performance in a number of areas since the bold move toward a more open and market-oriented economy that had begun in 1977. The results could be seen in the rapid rate of real economic growth and per capita income, and in reduced unemployment despite a drop in the terms of trade through the end of 1982 and political disturbances in 1983. Furthermore, the potential for sustained growth remained good. However, there were a number of weaknesses, both in current macroeconomic policy management and in structural reforms, that portended more difficult times ahead if they were not corrected.

The international community had been supportive of Sri Lanka's efforts in recent years, and foreign assistance had contributed importantly to financing the budget and the current account, Mr. Templeman continued. Consequently, there was strong interest in Sri Lanka's continued success in its economic adjustment and development efforts. Although Sri Lanka had had success in achieving a rapid rate of real economic growth, that growth had depended heavily on foreign savings, which had reached a peak of 19.8 percent of GDP in 1980 and had been 12.5 percent of GDP in 1983. Foreign savings had thus averaged almost half of all savings in the period 1978-83. Such a savings pattern was clearly unsustainable over the medium term and highlighted the need to achieve positive savings in the public sector and to raise the level of private savings. The resurgence of inflation in 1983 was also disturbing; it raised doubts about the ability of the authorities to cut the rate to 10 percent in 1984. The belief that that target would be reached appeared to be based on the absence of the adverse one-time factors that had prevailed in 1983 and the expectation of supply increases in the agricultural and manufacturing sectors. However, it was not clear whether past pressures, for example, from wages and monetary liquidity factors, would be consistent with such a deceleration of inflation. He had noted, in particular, the 40 percent rise in wages for state plantation workers.

As for the balance of payments, Mr. Templeman commented that the current account deficit as a percent of GDP, both excluding and including official transfers, was striking. While progress had been made in 1983 in reducing those ratios to 12.5 percent and 9.2 percent, respectively, and the high level of concessional foreign assistance to Sri Lanka had kept the debt service ratio to about the average for non-oil developing countries, the deficit ratio remained high by international standards. The ratio of foreign debt to GDP--58 percent in 1983--was well above the average, and the increase in foreign commercial borrowing in recent years would lead to a peak in debt service payments of about 27 percent in 1987/88. The performance of nontraditional exports, which had grown by

13 percent in 1982 and declined by 2 percent in 1983, had not been impressive relative to the need for export growth. It was also questionable whether Sri Lanka would be able to meet the current account target for 1984 unless domestic demand was better controlled so as to restrain imports to the targeted growth rate of 5 percent. The staff's medium-term balance of payments projections indicated a slow movement toward a current account deficit of about 5 percent of GDP between 1988 and 1990, with the improvement due more to import substitution, perhaps because of improvements in the energy sector, than to export growth. He invited the staff to comment on that aspect of the projections.

The stance of monetary policy was a clear weakness in present demand management, Mr. Templeman stated. While the adequate attention given in recent years to the credit needs of the private sector was welcome, the average rate of growth of such credit--more than 37 percent a year between 1980 and 1983--was excessive, and the overshooting of the 1984 target by 10 percentage points needed to be corrected. Some moderately restrictive credit measures had been taken in March and May 1984, but they were insufficient to reduce liquidity; the use of direct controls appeared inconsistent with the basically free market development strategy. A tighter rediscounting policy was needed and deposit interest rates would have to be maintained at substantially positive levels in real terms if domestic savings rates were to be raised to acceptable levels. In view of the importance of higher domestic savings, other institutional incentives might be useful to stimulate private savings.

It was difficult to evaluate the overall impact of fiscal developments because of the lack of data for the entire public sector, Mr. Templeman added, especially for the large group of public enterprises. He urged the authorities to improve their data collection and monitoring with regard to noncentral government fiscal operations, and he welcomed the special commission created for that purpose. The staff had appropriately suggested that the 1985 budget could be used as a vehicle to broaden the tax base and to increase tax buoyancy without creating disincentives to private savings and investment. The modest decline in the ratio of central government expenditures to GDP was welcome, but the overspending in 1984 and the possibility of similar overruns in future in such areas as treasury advances to public enterprises and larger than planned investment outlays were matters for concern. It was particularly disappointing that some of the new investment projects in the 1984 budget did not conform to investment guidelines. He invited the staff to elaborate on the recent and planned use of captive financing from the National Savings Bank and the Employees Provident Fund as sources of financing for the deficit.

The staff had made a good case that Sri Lanka had lost competitiveness since the late 1970s, Mr. Templeman remarked, irrespective of whether the wholesale price index or the consumer price index was used in calculating the real effective exchange rate. Other evidence was equally important, such as the disappointing performance of nontraditional exports, the continued use of subsidized export credit, and the direct credit controls affecting imports and exports. For a country that had opted to use pricing signals throughout the economy in order to ensure efficient resource allocation, the situation was particularly disappointing.

In sum, Mr. Templeman concluded, the achievements of the Sri Lanka authorities under difficult circumstances should not be ignored; the potential for good economic performance existed, but current monetary, fiscal, and exchange rate policies were perceptibly off track, both in terms of present demand management needs and longer-term requirements for stable growth and structural reforms. He urged the authorities to take prompt advantage of the time gained by the improvement in the terms of trade to deal with those problems. Mr. Jayawardena's comments on the intentions of his authorities in that regard were reassuring.

Miss Bulloch expressed broad agreement with the staff appraisal. The economy of Sri Lanka had made remarkable progress since the reforms in 1977; more recently, however, economic performance had been blown off course by the effects of the July 1983 disturbances. The external current account deficit for 1983 had turned out to be larger than expected under the stand-by arrangement, and inflation had been much higher than planned. The economic difficulties induced by the intercommunity problems would continue to complicate the authorities' economic adjustment efforts. They were to be commended for the steps that they had taken to reduce imbalances in the economy, in particular by redesigning the public investment program and by boosting export and savings incentives. While buoyant prices for the traditional export crops had provided a breathing space, as the staff had pointed out, it would be essential to achieve sustained growth of nontraditional exports in the medium term in order to secure a viable external position.

The sizable reduction in the budget deficit in 1983 was welcome, as was the further reduction to 9 percent of GDP envisaged under the revised 1984 budget, Miss Bulloch continued. However, the latter figure continued to be high, particularly since the greater part of it was expected to be financed from external sources, primarily foreign grants and concessional assistance. Aid receipts were projected to decline in the medium term with the completion of certain large capital projects, which underlined the importance of the restructuring of investment priorities that the authorities were undertaking and in which the World Bank could play a useful role. The improvement in revenues in 1983 was noteworthy, although the measures originally evisaged to broaden the tax base had not been implemented. A number of revenue measures were only temporary, and the likely medium-term constraints on external budgetary financing suggested that plans for a more thorough restructuring of the tax system should be be carried out. In view of the importance of the publicly owned enterprises in the Sri Lanka economy, it was disappointing that the staff had devoted only half a page in SM/84/150 to that subject. Was it possible to estimate the contribution of those enterprises to a comprehensively defined fiscal deficit? Was there a danger that the fiscal measures of the Central Government could be undermined by weak financial control of the public enterprises?

The authorities' recognition of the need to reduce excess liquidity in the economy was welcome, Miss Bulloch commented. She supported the objective of bringing inflation down to less than 10 percent by the end of 1984. Part of the substantial liquidity overhang from 1983 was the result of central bank rediscounting for tea exporters. The staff argued that such concessional financing was unnecessary at a time of high commodity prices. However, the need might re-emerge toward the end of 1984 if tea prices declined as expected. Given the persistent high rate of inflation, the strong demand for credit, and the shortage of domestic savings, she hoped that the authorities would keep open the possibility of raising interest rates, as suggested by the staff. She welcomed their stated willingness to take additional measures if necessary, and she invited Mr. Jayawardena to indicate what specific contingency measures the authorities had in mind.

The outlook for medium-term external debt underlined the importance of achieving a reduction in the current account deficit, Miss Bulloch suggested. Given the long lead time for the rehabilitation of traditional exports, either reduced imports or further increases in nontraditional exports would have to take the strain in the next few years, when it would be important that the international competitiveness of Sri Lanka was protected, particularly through a flexible exchange rate policy. At the same time, further direct investment from abroad could play a role in helping to stimulate nontraditional exports and to reduce reliance on external borrowing. Finally, the present tariff structure did not appear to be conducive to the maximization of Sri Lanka's export potential. She hoped that the further action planned by the authorities for the second half of 1984 would go a considerable way toward correcting the problem. However, a more efficient tariff structure might damage tax receipts; she invited the staff to comment on that question.

Mr. Wang observed that the stand-by arrangement with Sri Lanka for 1983/84 had been interrupted halfway through the program as a result of unexpected developments. Nevertheless, significant progress had been made in reducing the fiscal and external deficits--two of the three main objectives of the program--while economic growth had been maintained at the satisfactory level of 4 percent. The Sri Lanka authorities should be commended for those achievements.

The slippage in monetary policy had, however, led to an acceleration in the rate of inflation, which constituted a serious threat to economic stabilization at present, Mr. Wang continued. The authorities appeared to be fully aware of the seriousness of the problem and they had begun to take measures to bring inflation to less than 10 percent by the end of 1984. On the other hand, some of the important infrastructural projects were beginning to yield results and, in the external sector, Sri Lanka's terms of trade have shown marked improvement in line with the economic recovery, after five consecutive years of deterioration. Those developments were helpful to Sri Lanka's efforts to attain a viable balance of payments position over the medium term; Mr. Jayawardena had testified to the determination of his authorities to persevere in such efforts.

In EBS/84/165, the staff appeared to suggest that, using the index of the information notice system, the rupee had appreciated more than 10 percent in real effective terms since the previous discussion by the Executive Board of the Sri Lanka economy. However, in SM/84/150, Table 2, which dealt with Sri Lanka's performance criteria, showed that the exchange rate of the rupee had met tests on both occasions in 1983 by using an adjusted trade-weighted index. On the basis of either the trade-weighted index or the wholesale price index, the information in SM/84/173 indicated that there had been no significant appreciation through April 1984, although there had been some appreciation using the consumer price index measurement. Why had one standard been used in judging adherence to the performance criteria while another had been used in the supplementary notice? Which standard was more appropriate in Sri Lanka's case?

Mr. Ramtoolah expressed the support of his chair for the proposed decision. Despite difficult internal circumstances and other exogenous events, including a severe drought in 1983 and a worsening economic environment, the Sri Lanka economy had performed satisfactorily over the recent period. The momentum in economic growth had been maintained while progress had been achieved in reducing the fiscal and external deficits.

Major imbalances remained in the economy, Mr. Ramtoolah continued, and the maintenance of the adjustment effort was clearly warranted. The areas of concern had already been underlined by several speakers, including the poor performance of the public corporations, a less than adequate performance of public savings, excess liquidity, and recent increases in inflation and external indebtedness. The authorities were addressing some of those problems, for which they should be commended. However, the relatively poor prospects of Sri Lanka's traditional exports were worrisome; in particular, the high tea prices prevailing in recent months were the result of exceptional circumstances which, in all probability, would not continue for long.

Perhaps most important, Mr. Ramtoolah remarked, the medium-term and long-term outlook of the Sri Lanka economy hinged critically on the possibility of a resurgence of the unfortunate internal events that had caused so much economic damage. His chair fully supported the authorities' policies to promote greater peace and harmony, as a matter of urgent priority in order to strengthen national unity, as Mr. Jayawardena had indicated. Indeed, no adjustment effort could be successful in the absence of such national unity.

The staff representative from the Asian Department, commenting on the underlying assumptions in the medium-term balance of payments projections regarding exports and imports, noted that one of the most important element in exports, namely, the tree crop, was not projected to grow significantly in the next six years or so because of the serious deterioration of the plantations--a problem that the authorities had started to tackle in earnest only recently--and the long gestation period of the rehabilitative effort under way. The increase in tree crop exports was expected to be about only 2 percent a year in volume terms until 1990 on the basis of investment plans prepared by the World Bank and the authorities. As a result, there would be a substantial constraint on the balance of payments. Nontraditional exports, on the other hand, were projected to increase by close to 15 percent a year in nominal terms if appropriate adjustment policies were followed. Thus, the balance of payments scenario presented in SM/84/150 was a normative scenario, in that it depended on the authorities taking the necessary measures. A relatively modest growth of imports was forecast, because of import substitution and the expected reduction in public investment in the course of adjustment. Oil imports were expected to decline in volume terms starting in 1988, leveling off after three or four years if no further energy substitution projects were undertaken. It was possible, however, that more hydropower projects might be implemented.

The National Savings Bank had done a good job in mobilizing private savings, particularly in the rural areas, where commercial banks were often unwilling to go, the staff representative continued. Various intervention measures by the Government had tended to put downward pressure on interest rates, for example, forcing the National Savings Bank to invest in treasury bills at below market rates. The staff had suggested, therefore, that such intervention should be reduced and that the interest rate on treasury bills should be allowed to rise to market levels. The staff had also suggested, and the authorities had agreed, that there should be a reduction in borrowing by the Government from the National Savings Bank. The possibility was being explored that the resources thereby freed could be invested in housing as was done by similar savings banks in other countries. It would take time to judge how successfully the new approach would be implemented.

No effective system of monitoring the financial operations of the public enterprises existed, the staff representative remarked, and the staff had, therefore, not been able to produce a table containing a statement of the consolidated public sector financial operations. Many ministries had responsibility for the state enterprises, and coordination was difficult. Recent improvements in the financial positions of the enterprises were the result of a number of specific factors, including increases in tea and other commodity prices, but such increases could prove temporary. It was hoped that the implementation of the rehabilitation program would enable the enterprises to cope with a decline in tea prices when it occurred. Other factors contributing to the improvement in the financial position of state enterprises had been the recent adjustments in petroleum and electricity prices and the closing of some inefficient operations. However, the position could deteriorate quickly if inflation continued and if administered prices were not adjusted in time to prevent the emergence of a deficit. In such circumstances, the public enterprises would have to rely on financing from the budget, credit expansion, or foreign borrowing. Since their underlying position remained weak, the need for further action was essential.

A reduction in effective protection could affect tax receipts to some extent, the staff representative said. However, the Fund staff and the staff of the World Bank had suggested that a reduction in effective protection should be accompanied by an exchange rate adjustment in order to maintain incentives in the traded goods sector. The decline in tax receipts might, therefore, be prevented. If, nevertheless, tax receipts declined, offsetting budget measures should be taken.

The formula used to measure the effective exchange rate as part of the performance criteria under the stand-by arrangement had been based on the wholesale price index adjusted to exclude export prices, the staff representative from the Asian Department explained. Because the data on prices became available only with a lag of two or three months, that methodology worked in such a way that there could be an ex post appreciation in the rate, even if the authorities complied fully with the formula. If prices were increasing at a faster rate in Sri Lanka than in its trading partners, as had in fact occurred, there would be an appreciation of the exchange rate, which was precisely why a review of the exchange rate policy had specifically been foreseen for the midterm review under the stand-by arrangement. The formula thus provided only a general guideline for the conduct of exchange rate policy. The increase in the consumer price index had generally been greater than the increase in the wholesale price index since 1978 because the former gave greater weight to domestically produced goods, and inflation had been basically domestic in origin as a result of rapid monetary expansion. Neither index was a perfect indicator of cost increases and, while wages were indexed to the consumer price index, the staff looked at both measures in the context of exchange rate policy.

Mr. Jayawardena said that he was confident that in the course of their forthcoming review of the economic situation, his Sri Lanka authorities would acknowledge the need to take strong adjustment measures despite the recent improvement in the balance of payments. They were well aware that deferment of such measures would only make adjustment more difficult in future; furthermore, the authorities had shown a willingness to take action in similar difficult situations in the past.

The slight easing of monetary policy that had occurred in early 1983 had followed the sharp decline in inflation toward the end of 1982, as a result of which interest rates had become positive in real terms, with negative implications for long-term investment prospects, Mr. Jayawardena continued. At the same time, the fiscal deficit had shown a substantial contraction. When the monetary relaxation and credit operations following the July disturbances had appeared likely to rekindle inflationary pressures, the Sri Lanka authorities had intensified credit controls in late 1983, and they stood ready to tighten credit further in 1984 if necessary. He did not have information on the specific contingency measures that the authorities were contemplating, but a reduction in central bank refinancing operations was one possibility.

There did not appear to be justification for the view that real interest rates had been negative for most of the period between 1977 and 1983, Mr. Jayawardena suggested. The inclusion of certain minimum rates in Table 49 of SM/84/173 distorted the picture somewhat because those rates had been inoperative in the period of high interest rates prevailing in Sri Lanka since 1977. However, it was true that central bank refinancing operations had tended to lower the cost of credit; on the other hand, the volume of credit provided by the Central Bank was not large in relation to the overall stock of credit and the Bank was currently taking action to reduce its refinancing facilities. The issuance of central bank securities had already mopped up 30-40 percent of the estimated excess liquidity in the economy.

Commenting on the exchange rate, Mr. Jayawardena observed that the widening divergence between nominal and real effective rates, as illustrated in Chart 4 of SM/84/150, would have been less if the base year had been earlier than 1977 when a major exchange rate reform had been adopted. Given the current state of the art and the statistical weaknesses associated with calculations of effective exchange rates, it was advisable to assess the situation using various yardsticks as well as observations of market behavior. An overall assessment required the exercise of some degree of judgment. While his authorities preferred the use of the wholesale price index, their main concern was not a particular methodology but the adoption of a flexible exchange rate policy. Whatever the weaknesses of the wholesale price index approach, it had been useful in gaining acceptance within Sri Lanka of the concept of flexibility in the sensitive area of the exchange rate. Moreover, despite the interruption of the stand-by arrangement in January 1984, his authorities had continued to apply that approach, until one month earlier when additional reform proposals had been put forward. He hoped that the issue could be resolved in the near future. As the staff representative from the Asian Department had explained, the real effective appreciation of the rate, as measured in EBS/84/165, had occurred on an ex post basis as a result of the lag in the availability of data. Future exchange rate adjustments would be accompanied by tariff reforms; in that regard, he agreed with the comments of the staff representative. Indeed, an appreciation of the real effective exchange rate of the rupee would be counterproductive for Sri Lanka; he hoped that corrective measures would be adopted early. Technical assistance from the Fund could prove useful in helping his authorities resolve some of the differences of view on the subject within the country.

The fiscal deficit remained large, despite the recent decline, Mr. Jayawardena remarked, reflecting in large part investment outlays. However, the deficit--8 percent of GDP--did not appear excessive in comparison with deficits in some other developing countries. Of course, the economy could not depend indefinitely on foreign resources and the authorities were seeking to boost domestic savings in the medium term; in fact, there had already been some improvement in domestic savings since the period when the terms of trade had deteriorated. Nevertheless, foreign savings would probably remain important for some time.

The performance of the public corporations in 1983 had been heavily affected by financial transfers to the budget of the textile corporation to settle long-standing liabilities that had remained in the Government's accounts following denationalization of some textile factories, Mr. Jayawardena noted. In general, his authorities preferred not to subsidize public corporations but, in practice, the corporations sometimes found their way around the regulations designed to make them independent.

The Acting Chairman made the following summing up:

Executive Directors commended the Sri Lanka authorities for the economic progress achieved on many fronts following the wide-ranging liberalization measures introduced in 1977 and 1978, and for the maintenance since then of an open, liberalized economy despite a sharp deterioration in the international economic environment. However, Directors observed that, because the Government had been unable to increase the mobilization of resources and to improve export performance, Sri Lanka had relied on foreign borrowing to finance a high level of public investment and that it was now faced with a sharp increase in its external debt service burden and a possible slowdown in investment and assistance flows. The situation called for a strong, sustained adjustment effort during the years ahead.

Directors commended the authorities for the adjustment measures undertaken in 1983 under the stand-by arrangement with the Fund in spite of difficult internal political and social developments. They welcomed the significant reductions in the fiscal and external current account deficits in 1983 but noted there had been deviations from the Fund program under the stand-by arrangement in some important areas, such as credit expansion, domestic financing of the budget, the much higher domestic rate of inflation, and, despite more favorable export prices, the external current account deficit. While drought and civil disturbances had been partly responsible for those less favorable developments, an easing of financial and wages policies had also been important contributing factors.

Directors agreed that the current high tea prices had to be regarded as a temporary phenomenon, which should not prompt the authorities to relax the adjustment effort. They expressed concern about the continued high rate of domestic inflation and welcomed the credit and monetary restraint measures taken in late 1983 and in 1984. However, strong emphasis was placed on the need for further tightening of monetary policy. In that connection, Directors called for a tightening of the Central Bank's rediscounting facilities and for increased flexibility in interest rate policy. Directors were also concerned that wage policies could make it more difficult to achieve the Government's inflation objective.

Directors stressed the need for increased mobilization of domestic resources. Noting the decline in the ratio of tax revenue to GDP in recent years and the temporary nature of the revenue measures introduced in 1984, they regretted that the 1984 budget had not included significant measures to increase the buoyancy and efficiency of the tax system; therefore, they called for comprehensive, sustainable measures to broaden the tax base in the 1985 budget and beyond. Directors also urged the authorities to take concrete measures as soon as possible to improve the efficiency and financial performance of public enterprises. In that connection, they welcomed the steps taken to improve the collection of data and to monitor public enterprises.

Directors noted with satisfaction the measures taken in 1984 to rehabilitate the state plantation sector, including the adoption of a performance-related incentive scheme and the drawing up of a comprehensive medium-term investment plan. They also welcomed the continued scaling down of the Government's investment program to a more sustainable level and the adoption of new guidelines for public investment projects. They urged the authorities to adhere strictly to those guidelines.

Noting the significant appreciation in the real effective exchange rate of the rupee in the recent past, Directors underscored the importance of following a more flexible exchange rate policy. They cautioned that the current high world prices of Sri Lanka's traditional export crops should not mask the need for a strengthening of competitiveness and for diversification efforts in the nontraditional export sector. Because the present high tariff protection system introduced a general bias against exports, Directors urged a reduction in the effective protection level in order to encourage the development of an efficient, internationally competitive industrial sector. As the Sri Lanka authorities themselves agreed that the limits of import substitution were gradually being reached, it was imperative for Sri Lanka to create conditions in which economic growth could be supported by strong export growth in the future.

In sum, Directors welcomed the adjustment measures undertaken since 1983, but stressed that those measures were only a first step toward achieving balance of payments viability, which depended crucially on an improved export performance and increased mobilization of domestic resources. Therefore, a strong, continued adjustment effort was essential.

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

The Executive Board then took the following decision:

Decision Concluding 1984 Article XIV Consultation

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.

Decision No. 7780-(84/124), adopted
August 8, 1984

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/123 (8/6/84) and EBM/84/124 (8/8/84).

3. ROMANIA - 1984 ARTICLE IV CONSULTATION - POSTPONEMENT

The Executive Board notes the request contained in EBD/84/212 (8/3/84). Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1984 Article IV consultation with Romania to not later than September 12, 1984.

Decision No. 7781-(84/124), adopted
August 7, 1984

4. 1984 ANNUAL MEETING - FORMAL NOTICE AND BRIEF AGENDA

The Executive Board instructs the Secretary to communicate the notice and brief agenda for the 1984 Annual Meeting by cable and by airmail letter to all Governors and Alternate Governors. (EBD/84/209, 7/31/84)

Adopted August 7, 1984

5. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 84/22 through 84/24 are approved. (EBD/84/206, Sup. 1, 7/31/84)

b. The minutes of Executive Board Meeting 84/26 are approved. (EBD/84/210, 7/31/84)

Adopted August 6, 1984

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/165 (8/3/84) and EBAP/84/166 (8/6/84) is approved.

APPROVED: May 23, 1985

LEO VAN HOUTVEN
Secretary