FOR AGENDA

EBS/83/166

CONFIDENTIAL

August 9, 1983

To: Members of the Executive Board

From: The Acting Secretary

Subject: Sri Lanka - Staff Report for the 1983 Article IV Consultation and Request for Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Sri Lanka and its request for a stand-by arrangement equivalent to SDR 100 million. Draft decisions appear on page 25.

This subject will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Chabrier, ext. (5)7610 after Monday, August 15, 1983.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

SRI LANKA

Staff Report for the 1983 Article IV Consultation and Request for Stand-By Arrangement

Prepared by the Staff Representatives for the 1983 Consultation with Sri Lanka

(In consultation with the Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by Tun Thin and Manuel Guitian

August 8, 1983

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I. Introduction

The 1983 Article IV consultation discussions with Sri Lanka were held in Colombo during July 5-20, 1983. Discussions also took place on a financial program in support of which the Minister of Finance and Planning and the Governor of the Central Bank of Ceylon, in the attached letter dated August .., 1983, request a stand-by arrangement for the period through July 31, 1984 in an amount of SDR 100 million, or 56.02 percent of quota. Financing of the proposed stand-by arrangement would be SDR 43.0 million from ordinary resources and SDR 57.0 million from borrowed resources. It is proposed the amount be made available in five installments as indicated in Table 1. A waiver of the limitation in Article V, Section 3(b)(iii) of the Fund Agreement is required.

The Sri Lanka representatives included Dr. Rasaputram, Governor of the Central Bank of Ceylon, Dr. Tilakaratna, Secretary of Finance and Planning, and officials from the Central Bank, various ministries and public corporations. The staff team included Messrs. Chabrier (ASD, head of mission), Golle (ASD), Paljarvi (ETR), Katz (FAD), Nord (EP, ASD), and Miss Eugenio (secretary FAD). It was assisted by Mr. Mountford, the Fund resident representative, and Mr. Lateef, the IBRD resident representative in Colombo. Mr. A.S. Jayawardena, Alternate Executive Director for Sri Lanka, attended the meetings as an observer.

Disturbances occurred in the last week of July in Sri Lanka after the return of the mission to headquarters. The staff has remained in contact with the authorities who have indicated their firm intention to carry out the negotiated program and to adhere to the quantified credit limits, even though they recognize that such adherence will in all likelihood involve some shift of budgetary resources from development to relief expenditure. The staff will provide an assessment of the most recent developments before consideration of the program by the Executive Directors.

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

II. Economic Background

The liberalization policies of 1977 resulted in a strong and broadly based rebound in economic activity, with the notable exception of the tree crop sector.1/ The investment ratio rose to an average of 30 per cent of GDP in the early 1980s, the infrastructure of the economy was greatly improved, and major bottlenecks were reduced. The growth of real GDP averaged close to 6 per cent per year, more than

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1/ These policies were supported by a one-year stand-by arrangement from the Fund, followed by an extended arrangement for the period 1979-81. Performance under these arrangements was assessed in SM/82/155 (7/30/82).

Table 1: Sri Lanka: Schedule of Proposed Purchases 1/
and Repurchases during the Proposed Stand-by Arrangement Period

	1983		1984		
	July-Sept.	Oct.-Dec.	Jan.-Mar.	Apr.-June	July-Sept.
	(In millions of SDRs)				
Purchases under tranche policies	10.0	20.0	20.0	25.0	25.0
Ordinary resources	6.13	13.33	13.33	10.21	--
Enlarged access	8.37	6.67	6.67	14.79	25.0
Repurchases	8.1	1.6	3.3	3.3	6.5
EFF	3.3	--	3.3	3.3	3.3
Stand-by	4.8	1.6	--	--	--
CFF	--	--	--	--	3.2
Buffer Stock	--	--	--	--	--
Net purchases	1.9	18.4	16.7	21.7	18.5
Memoranda items:					
Total holdings (end-of-period)	485.3	503.7	520.4	542.1	560.6
Excluding compensatory financing and buffer stock	441.2	459.6	476.3	498.0	519.6
	(In per cent of quota)				
Total holdings (end of period)	271.9	282.2	291.5	303.7	314.1
Excluding compensatory facility and buffer stock	247.2	257.5	266.8	279.0	291.1

Source: Data provided by the Treasurer's Department.

1/ The first purchase under the arrangement (SDR 10 million) will be effected soon after the Executive Board approval (around mid-September); the other purchases will be based upon satisfaction of performance criteria as of end-August and November 1983 and end-February and May 1984.

double the rate in the six years before 1977. The substantial increases in paddy production have brought Sri Lanka on the verge of self-sufficiency in rice. The resulting gains in employment and job opportunities abroad helped to nearly halve the unemployment rate to 14 per cent over the period (Table 2). At the same time, however, little progress was achieved in solving important structural weaknesses of the economy in such areas as state plantations, excessive protection, and lack of elasticity of the tax system.

The removal of import controls in 1977 led to a revival of private investment and increased the demand for imports, but cyclically high export prices and rising foreign aid inflows permitted Sri Lanka to maintain its gross official foreign exchange reserves at over four months of imports in the 1977-78 period. From mid-1979 onward, however, the foreign economic environment was much less favorable; in particular, the external terms of trade declined by over 20 percent between 1979 and 1981. As domestic demand continued to grow rapidly, inflation averaged over 30 percent a year in 1980 and 1981, and the current account deficit of the balance of payments rose from 5.5 percent of GDP in 1978 to a level averaging 16.5 percent of GDP in the two-year period 1980-81. These current deficits were considerably larger than could be financed by net concessional aid inflows. Despite the start of substantial commercial borrowings abroad by the public sector, the cumulative overall deficit of the balance of payments was nearly SDR 200 million in 1980-81.

Economic performance in 1982 was adversely affected by poor weather conditions and continued weak prices for export commodities. Moreover, pre-electoral considerations delayed needed policy adjustments. Output in most manufacturing units recovered strongly from the 1981 level when production had been affected by power shortages. Although the growth of agricultural output was modest, real GDP rose by 5 percent. Domestic demand increased by 3.6 percent in real terms, largely on account of a recovery in public investment following cuts in 1981 and of buoyant private consumption under the combined impact of substantial wage adjustments--real incomes in the public sector rose by about 10 percent--and a lack of official price adjustments.

Budget policy, which had been contractionary in 1981, was again expansionary. Budget revenue rose by only 9 percent because of a one-third decline in export tax receipts--due to falling commodity prices and reductions in the export duty rate for tea--and administrative difficulties in the collection of the business turnover tax (BTT). In contrast, total budget expenditure rose by 19 percent. Three categories of expenditures rose particularly sharply: interest payments (33 percent) as a result mostly of the rapidly rising debt level; the wage bill (21 percent) on account of a restructuring of wage scales and the introduction of an automatic monthly cost of living adjustment scheme; and capital expenditures (35 percent) largely on account of the construction path of the Mahaweli hydro-irrigation project. As a result, the overall budget deficit was 30 percent larger than in

Table 2: Sri Lanka: Principal Indicators of Economic Trends and Policies

	1978	1979	1980	1981	1982	1983	1984
Real GDP (% change)	8.2	6.3	5.8	5.8	5.1	4.6	5.5
Inflation (CPI)	9	19	38	24	11	13	8
Unemployment rate	24	19	15	14	14	13	13
Terms of trade (% change)	-5	-3	-15	-6	7	17	1
Balance of payments							
Current account deficit/GDP	5.5	11.1	19.8	13.3	15.3	12.2	10.5
Overall balance (mn. SDR)	65	35	-166	-26	-24	-13	21
Gross official reserves (mn. SDR)	306	392	193	289	313	288	...
(In months of imports)	(4.5)	(4.2)	(1.5)	(2.2)	(2.0)	(2.0)	...
Net international reserves (mn. SDR)	161	196	30	4	-20	-52 1/	...
External debt outstanding (As % of GDP)	46	42	46	53	57	68	...
Debt service ratio 2/	17	12	12	16	19	22	21
Budget							
Overall deficit/GDP	13.8	13.9	23.1	15.6	17.2	14.6	11
Bank financed deficit/GDP	0.4	1.2	10.6	4.5	3.7	0.3	--
Credit							
Net domestic assets of banking system (% increase)	9.6	45.5	70.8	26.7	31.2	15.9	...

Sources: Central Bank of Ceylon; and data provided by the Sri Lanka authorities.

1/ May 1983.
2/ Including obligations to the Fund.

1981--equivalent to 17.2 percent of GDP--and recourse by the Government to domestic resources amounted to 9 percent of GDP (Table 3).

In response to the restrictive monetary policy stance and the removal of some private investment incentives decided upon in mid-1981, the expansion of credit to the private sector decelerated from 34 percent in 1981 to 24 percent in 1982. But because of the substantial credit expansion to the public sector, net domestic assets of the banking system rose by 31 percent (27 percent in 1981), a large increase when viewed against the decelerating trend in inflation (Table 4). Higher foreign borrowings by the public sector kept the overall deficit of the balance of payments small and the credit expansion was reflected in an increase of 25 percent of broad money.

Notwithstanding the expansionary financial policies, the rate of inflation decelerated to 11 percent, on average, in 1982 and to less than 2 percent in the 12 months to December 1982. This development was the result of reduced world inflation, the expectation of good paddy crops, and policies to repress price increases: the administered prices of several commodities (rice, wheat flour) were reduced in the second half of 1982 while exchange rate policy resulted, in practice, in a close link between the rupee and the appreciating U.S. dollar.

The impact of the financial and exchange rate policies was mostly felt on the balance of payments. Imports were 15 percent larger in SDR terms than in 1981, even though food imports declined (Table 5). Meanwhile, export receipts rose by only 3 percent, mostly because of lower export prices for rubber and coconuts. In addition, the growth of nontraditional exports (12 percent) was less than half the average increase in the previous two years, the result of weak world demand, foreign market restrictions, domestic supply constraints, and loss of competitiveness of some sectors. The traditional surplus on services moved into a deficit as the growth of tourist receipts slowed down and interest payments rose. Notwithstanding a further strong increase in private inward remittances, the current account deficit widened to SDR 668 million, or 15.3 percent of GDP, but the overall deficit was limited to SDR 24 million as a result of a considerable step-up in nonmonetary capital inflows.

Pressures on the balance of payments were particularly strong after September 1982. In order to forestall a drain on its foreign exchange reserves, the Central Bank increased its outstanding short-term foreign borrowings from SDR 16 million in September 1982 to SDR 123 million in February 1983. Nevertheless, by early 1983, gross official reserves remained at two months of imports, and net official reserves were negative. Also, the external debt had increased to SDR 2.5 billion, or nearly 60 percent of GDP, from SDR 1.1 billion (42 percent of GDP) at end-1979, an increase that was accompanied by a marked hardening in both terms and maturity profile of the debt (Table 6).

Table 3: Sri Lanka: Central Government Budget, 1979-83

	1979	1980	1981	1982 Prov.	1983 Budget	1983 Revised
			(In millions of Sri Lanka rupees)			
Revenue	12,029	13,262	15,259	16,610	22,710	22,700
Total expenditure	19,255	28,630	28,498	33,858	42,412	40,200
Current	11,908	15,770	16,741	18,024	24,446	23,300
Capital	7,347	12,860	11,757	15,834	17,966	16,900
Overall deficit	-7,226	-15,368	-13,239	-17,248	-19,702	-17,500
Foreign financing (net)	3,738	6,136	7,602	8,121	12,606	12,050
Concessional aid	3,738	6,136	5,902	6,896	10,776	10,685
Commercial borrowings	--	--	1,700	1,225	1,830	1,365
Exceptional transfer 1/	--	--	--	--	1,500	1,500
Domestic financing	3,488	9,232	5,637	9,127	5,596	3,950
Nonbanks	2,854	2,197	1,790	5,372	4,235	3,650
Banks	634	7,035	3,847	3,755	1,361	300
			(As a per cent of GDP)			
Revenue	23.1	19.9	17.9	16.6	18.9	18.9
Total expenditure	37.0	43.0	33.5	33.8	35.3	33.5
Overall deficit	13.9	23.1	15.6	17.2	16.4	14.6
Concessional foreign aid	7.2	9.2	6.9	6.9	9.0	8.9
Foreign commercial borrowings	--	--	2.0	1.2	1.5	1.1
Domestic financing 2/	6.7	13.9	6.6	9.1	5.9	4.6
Bank financing	1.2	10.6	4.5	3.7	1.1	0.3
			Fiscal impulses (as a per cent of GDP) 3/			
Revenue impulse	5.51	3.28	1.66	1.06	-2.35	-2.40
Expenditure impulse	-6.65	5.76	-8.84	-0.25	0.98	-0.91
Total impulse	-1.14	9.04	-7.18	0.81	-1.38	-3.31

Sources: Ministry of Finance and Planning; and Central Bank of Ceylon.

1/ This consists of the transfer of SL Rs 1.5 billion of Central Bank profits to the budget effected in early 1983. The Sri Lanka official budget presentation includes this item in revenue.

2/ Including the exceptional transfer from the Central Bank.

3/ For methodology, see World Economic Outlook, 1981, p. 104-5.

Table 4. Sri Lanka: Monetary Survey, 1979-83

	1979 Dec.	1980 Dec.	1981 Dec.	1982 Dec.	1983 May	1983 Dec.1/
	(In millions of Sri Lanka rupees)					
Net foreign assets	4,050	1,080	685	-718	-1,618	-1,137
Net domestic assets	10,907	18,629	23,602	30,966	33,829	35,878
Public sector	6,307	13,223	17,377	21,913	21,103	22,735
Government (net)	2,962	9,100	12,889	17,235	16,644	17,535
Public corporations	3,345	4,123	4,488	4,678	4,459	5,200
Private sector 2/	7,736	12,196	16,342	20,256	23,501	25,100
Other (net)	-3,136	-6,790	-10,117	-11,203	-10,775	-11,957
Monetary liabilities (M2)	14,957	19,709	24,287	30,248	32,211	34,741
Money	7,643	9,333	9,950	11,672	12,490	...
Quasi-money	7,314	10,376	14,337	18,576	19,721	...
	(Percentage increase over 12-month period)					
Net domestic assets	45.5	70.8	26.7	31.2	17.2	15.9
Public sector	(48.3)	(109.8)	(31.4)	(26.1)	(-0.4)	(3.8)
Private sector	(25.8)	(57.7)	(34.0)	(24.0)	(32.3)	(23.9)
Monetary liabilities	38.5	31.8	23.2	24.6	12.1	14.9
	(Increase as per cent of M2 at beginning of year)					
Credit to:						
Public sector	19.0	46.2	21.1	18.7	--	2.7
Private sector	14.7	29.8	21.0	16.1	20.0	16.0

Source: Central Bank of Ceylon.

1/ Projections under the Central Bank Credit Plan.
2/ Includes cooperatives.

Table 5. Sri Lanka: Balance of Payments, 1980-84

(In millions of SDRs)

	1980	1981	1982	1983 1/	1984 1/
A. Merchandise	-758	-684	-892	-792	-764
Exports, f.o.b.	818	908	934	971	1,111
Imports, c.i.f.	-1,576	-1,592	-1,826	-1,763	-1,875
B. Services	40	10	-16	-41	-49
Receipts	214	261	296	327	362
Payments	-174	-251	-312	-368	-411
C. Private transfers, net	105	172	240	263	290
D. Current account (A+B+C)	-613	-502	-668	-570	-523
(percent of GDP)	(-19.8)	(-13.3)	(-15.3)	(-12.2)	(-10.5)
E. Official transfers, net	106	136	147	150	160
F. Nonmonetary capital, net	306	339	471	407	384
Private sector and public corporations, net	181	115	240	137	84
Central government, net	125	224	231	270	300
Disbursements	201	268	298	343	370
Amortization and progress payments	-76	-44	-67	-73	-70
G. Errors and omissions	23	-11	26	--	--
H. SDR allocations	12	12	--	--	--
I. Overall balance	-166	-26	-24	-13	21
J. Monetary movements					
Gross official reserves (- = increase)	199	-96	-24	25	-69
Use of Fund credit	-23	136	-11	-17	48
Other items, net	-10	-14	59	5	--
Memorandum items:					
Gross commercial borrowing (flow)	221	195	349	164	140
Outstanding short-term borrowings by Central Bank (end of period	17	10	78	112 2/	...

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

1/ Forecast.

2/ End-May

Table 6. Sri Lanka: External Debt Disbursed

	1979	1980	1981	1982
		(In millions of SDRs)		
External debt outstanding	1,099	1,437	1,987	2,498
Medium- and long-term	1,081	1,285	1,820	2,240
(Fund credit)	(235)	(211)	(346)	(342)
Short-term	18	152	167	258
Debt service	110	126	189	235
(Fund)	(38)	(45)	(70)	(77)
Memorandum items		(In per cent)		
Outstanding debt/GDP	42	46	53	57
Short-term debt/total debt	2	11	8	10
Concessional debt/total debt	73	66	58	52
Debt service ratio	12	12	16	19

Source: Appendix Table 9.

Reflecting these developments and substantially higher interest rates on world markets, debt service payments rose to 19 percent of exports of goods and services in 1982.

From February 1983 onward, corrective measures to improve the balance of payments were taken: the rupee was devalued in steps from SL Rs 21.4 per U.S. dollar at end-1982 to SL Rs 22.9 per U.S. dollar in February; the administered prices of several commodities and government service fares were raised; new tax measures equivalent to 2.5 percent of GDP were introduced in the 1983 budget presented in March 1983; and the growth of public capital expenditure was reduced. However, the overall budget deficit was expected to decline to only 16.4 percent of GDP. Nethertheless, the balance of payments was forecast to improve in 1983 because of the reduction in oil prices, a strong recovery in export prices for tea, rubber, and coconuts, and projected substantial increases in emigrant remittances and aid inflows. However, as the adverse impact of a severe drought on the production of major export commodities became manifest, and in view of a strong import demand by the private sector in the first half of 1983 following the return of business confidence after the elections in the second half of 1982,

it became evident that only a modest external adjustment would take place in the absence of further policy measures. The authorities therefore decided to tighten budget and credit policies after mid-1983 and the rupee was devalued to SL Rs 24.20 per U.S. dollar on July 4. The authorities also adopted the financial program described below.

III. The Economic and Financial Program for June 1, 1983 to May 31, 1984

The Sri Lanka representatives stressed that given the constraints that the level and structure of domestic supply will impose on a rapid growth of exports in the short run, the external adjustment will take several years and will, in an initial stage, largely come from the containment of domestic demand. Most of the demand restraint measures under the negotiated program are already in place. Policies of a structural nature will also be initiated under the program.

1. Objectives of the program

The main assumptions, targets, and economic policies are summarized in Appendix Table 10. The main objectives of the program are a reduction in the current account deficit of the balance of payments to 12 percent of GDP in 1983 and to about 10 percent in 1984, while maintaining a high rate of economic growth and the present open and liberal economic system. The program also aims at containing the rate of inflation to 13 percent, on average, in 1983; slightly over half of the increase is on account of discretionary policy actions. After increasing to a projected 15 percent by September, the rate of inflation is expected to slow down to 10-11 percent by end-1983, and further to 8 percent by mid-1984.

The policies under the program consist of the provision of adequate incentives to producers of tradeable goods, largely through greater flexibility in exchange rate management; flexibility in official pricing policy; reductions in both the overall budget deficit and its domestic financing requirement; a tightening of the overall credit stance; and the maintenance of real positive interest rate levels. The program also contains specific undertakings by the authorities to initiate structural reforms in four areas: plantations; public investment; tax policy; and effective protection in the manufacturing sector. The authorities have started preliminary discussions with the World Bank on a program to be supported by a structural adjustment loan. Close contact has been maintained between the Bank and Fund staffs at headquarters and during the negotiations of the program in Colombo. 1/

1/ Relations between Sri Lanka and the IBRD are included in Appendix II.

2. Performance criteria and other commitments

The proposed stand-by arrangement contains performance criteria in the form of: (i) ceilings on net dometic assets of the banking system and credit to the public sector; (ii) limits on foreign borrowings in specified maturities; (iii) quarterly tests of the exchange rate of the rupee consistent with a predetermined formula; (iv) the standard provisions relating to the exchange and trade system; (v) and a mid-term review by the Fund before January 31, 1984 of performance and policies, but more particularly in the exchange rate, interest rate and budget areas as well as the progress made in the implementation of the structural reforms in the four areas mentioned above. Assessment of such progress would be done with the assistance of the IBRD staff.

3. Economic setting

Notwithstanding the improved business climate since the end of 1982 and the higher activity levels in manufacturing and construction, the authorities estimated that real GDP would increase by slightly less than 5 percent in 1983 because of the drought-induced reductions in the tea and coconut crops and the temporary closure of the oil refinery early in the year.

The Sri Lanka representatives estimated that the balance of payments in 1983 would benefit from both an improvement of 17 percent in the terms of trade and from the tightening of financial policies. About half of the improvement in the current account in 1983 is on account of policy action. Imports are forecast to fall by 3 percent in SDR terms on account of a reduction in oil and rice imports and lower investments by public corporations. The projected increase of 4 percent in exports mostly reflects the lower volume of exports of rubber, coconuts, and petroleum products. The main price and volume assumptions for foreign trade are described in Appendix Table 11. Notwithstanding an increase of 12 percent in tourist receipts--a slackening in arrivals from Europe being offset by higher arrivals from Asia--the deficit on the services accounts is estimated to grow further because of higher interest payments. Based upon data for the first half of 1983, emigrants remittances are conservatively projected to increase by 15 percent. As a result, the current account deficit of the balance of payments is estimated to decline by about SDR 100 million from its 1982 level to SDR 570 million (12 percent of GDP). The net inflow of nonmonetary capital is estimated to be slightly less than in 1982 due to reduced commercial borrowings by the public sector. As a result, the balance of payments is estimated to show a small overall deficit of SDR 13 million. Virtual overall balance is projected in the period of the program. Therefore, the proposed net purchases from the Fund (SDR 77 million) under the arrangement would permit some reduction in the short-term external liabilities of the Central Bank and allow a rebuilding of gross external reserves to over two months of imports which the authorities view as necessary given the vulnerability of the balance of payments.

Assuming normal weather conditions, a slight fall in tea prices but further increases in rubber and coconut prices, exports are forecast to recover by 14 percent in 1984. Meanwhile, on the basis of an estimated rate of growth of GDP of 5.5 percent, a moderate increase in import prices, and continued financial restraint, imports are estimated to grow by 6 percent. Despite a a further increase in the deficit on services on account of higher interest payments, and a tapering off in the growth of private inward remittances, because of a less favorable economic outlook in the oil producing countries of the Middle East, the current account deficit is estimated to be reduced further by some SDR 50 million to 10.5 percent of GDP; it is estimated to be more than covered by net capital inflows.

4. Economic and financial policies in the 1983/84 program

a. External policies

The real effective exchange rate of the rupee has been on a generally appreciating trend since 1978, although with corrections during some periods (Chart 1). Under the program, the authorities will adjust the exchange rate of the rupee at frequent intervals in order to at least maintain its competitiveness in real effective terms at the level reached after the July 1983 adjustment. The changes will be made on the basis of a trade-weighted exchange rate index deflated by relative monthly movements in wholesale prices for Sri Lanka and partner countries. 1/ The Central Bank would also limit its intervention in the exchange market to the smoothening of fluctuations around the trend, but would not resist fundamental trends. The Sri Lanka representatives noted that since it was difficult to determine with precision the degree of competitiveness of the rupee at any particular moment, developments in the external current account and net external reserves will also be important determinants of exchange rate policy.

The Sri Lanka representatives noted that other steps had been taken in the 1983 budget to price tradables at realistic levels. On the import side, many formerly duty-free imports are now subjected to a 5 percent import duty and most other duty rates have been raised. In order to encourage the export sector, the customs duty rebate scheme was extended to additional products, export taxes on tea and rubber were reduced, the BTT tax on gem exports was removed, and that on tourist hotels reduced; and exports continue to benefit from the five-year tax holiday on profits that was withdrawn in respect of all new activities initiated after March 1983. In the credit field, the Central Bank has improved and expanded its refinance schemes to non-traditional exporters. The staff cautioned that, while useful for a more dynamic export growth in the short run, the numerous tax and

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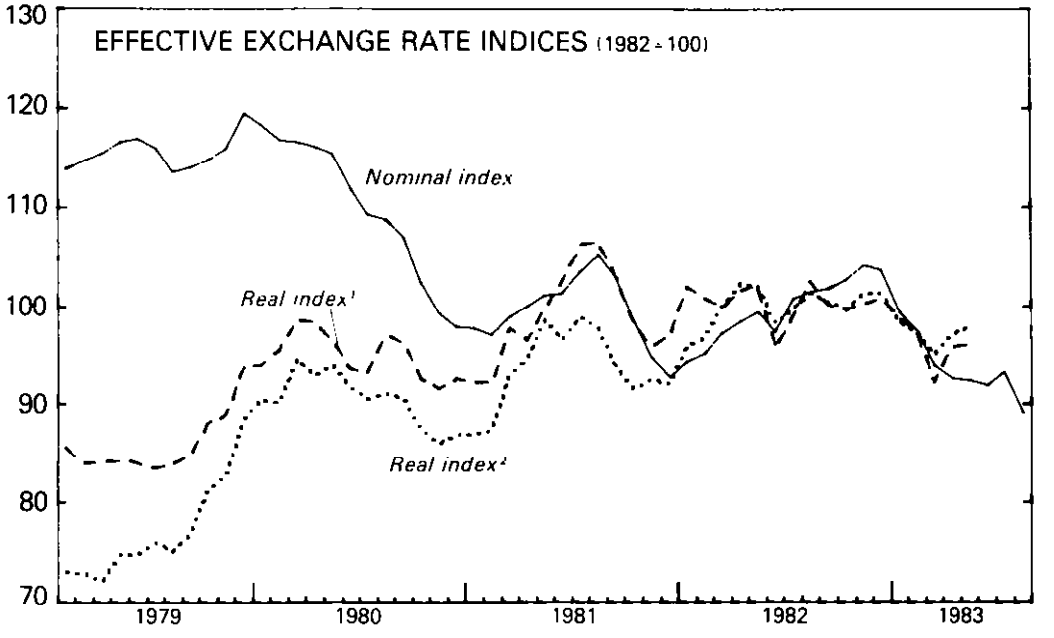
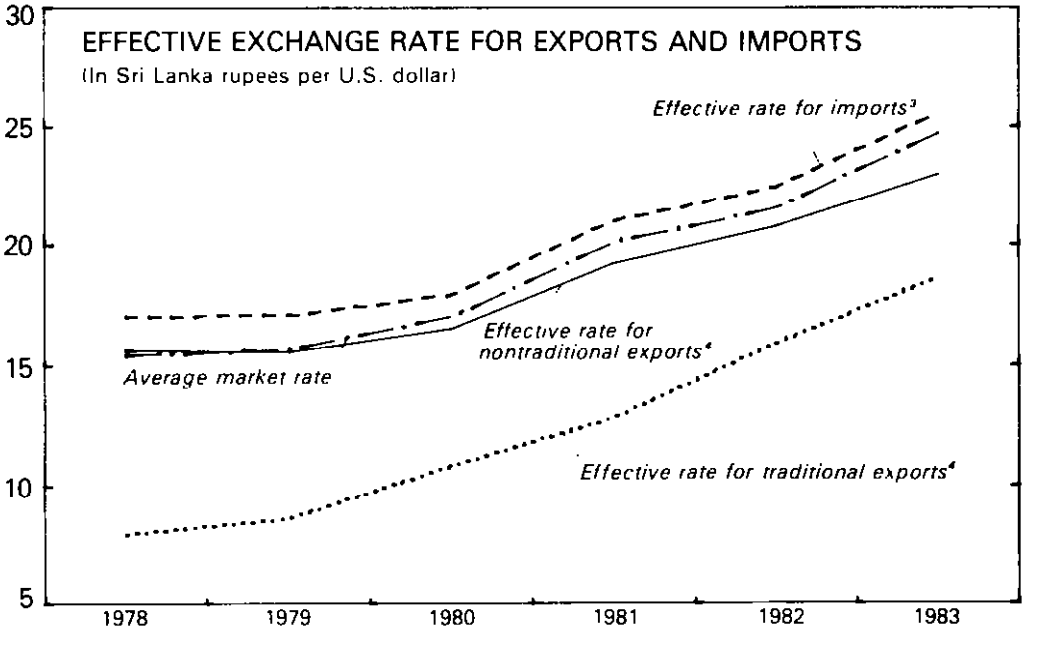
1/ The major export commodities (tea, rubber, coconuts), the prices of which are determined on world markets, have been eliminated from the WPI for Sri Lanka.

CHART 1

SRI LANKA

EXCHANGE RATE INDICATORS





Source: Staff calculations.

[1]Nominal index deflated by wholesale price indices, excluding, for Sri Lanka, export commodities.

[2]Nominal index deflated by consumer price indices.

[3]Market exchange rate adjusted for import taxes.

[4]Market rate adjusted for export duties net of export subsidies.

subsidy measures created price distortions and would only temporarily alleviate the constraints on exports.

Consistent with the policies of moderating the external debt service burden, the Sri Lanka representatives stressed that caution would be exercised in the contracting of foreign debt on commercial terms. Based on the projections of the external current account for 1983 and 1984 and the pipeline of external aid and commercial loans, the authorities intended to limit the contracting of nonconcessional external debt by the public sector (including the guaranteeing of debts by the Government) in the 1-12 year maturities to no more than SDR 50 million in the period June 1, 1983 to November 30, 1983. By mid-1983, the outstanding level of short-term external debt (SDR 258 million) was about the size of gross official reserves, a development that required prudence in further borrowings in short maturities. As a result, limits have been set for August and November 1983 on outstanding selected short-term debt in categories that can easily be monitored and are described in Table 7.

Borrowings by Sri Lanka residents from Foreign Currency Banking Units (FCBUs) are not covered by the above limits on short-term debt, the reason being the difficulties to monitor the disbursement of loans from these units, even though, at present, such borrowings need Central Bank approval. The staff noted that lendings by FCBUs to residents had been growing rapidly in recent years (from SDR 30 million outstanding at end-1980 to SDR 136 million in May 1983) and that such a rapid growth as well as the possible mismatch of maturities between the deposits and assets of these units could pose a problem in the future if left unchecked. The Sri Lanka authorities indicated that they would undertake in August 1983 a study of the operations of FCBUs with the assistance of the IBRD and the Commonwealth Secretariat, with a view to devising effective methods to monitor such lendings.

b. Budget policies

The 1983 budget introduced higher general sales and turnover tax rates, increases in import duty rates--including taxation of hitherto duty free items--and the removal of tax holidays (see Appendix Table 12 for details). The net impact of these measures was estimated at 2.5 percent of GDP in 1983; as a result, budget revenue was estimated to increase by 37 percent over 1982 actuals. Reflecting implementation constraints, the growth of capital expenditures was estimated at only 12 percent, implying no growth in real terms from the 1981 level. However, current budget expenditure was estimated to increase by 36 percent over 1982 actuals on account of large outpayments on advance accounts, higher interest payments and transfers to nonfinancial public

Table 7. Sri Lanka: Quantitative Performance Criteria

	1983 May	1983 Aug.	1983 Nov.
	(In millions of Sri Lanka rupees, end of period)		
I. Domestic credit			
Net domestic assets 1/			
Actual	33,829	...	...
Ceiling	...	34,500	36,000
Credit to public sector 2/			
Actual	21,103	...	...
Ceiling	...	22,000	22,300
	(In millions of SDRs)		
II. Foreign borrowing limits			
- New Commitments in 1-12 year maturity (cumulative)3/	...	50	50
- Outstanding short-term debt 4/	277	325	301
III. Exchange rate		5/	5/

Source: Data provided by the Sri Lanka authorities.

1/ The ceilings may be adjusted automatically to any decline beyond the projected path in any component of net domestic assets that is beyond the control of the authorities and could not be construed as equivalent to an increase in domestic credit.

2/ Defined as credit to the Government (net) plus credit to public corporations.

3/ Nonconcessional borrowings contracted or guaranteed by the public sector cumulative from June 1, 1983.

4/ Defined as outstanding short-term borrowings by Central Bank of Ceylon plus external borrowings by commercial banks (i.e., the items foreign banks deposits and foreign borrowings in their balance sheets) plus acceptance credits by the Ceylon Petroleum Corporation.

5/ The level of the exchange rate of the rupee will be tested at the end of August and November against the results provided by a trade-weighted index using relative price differentials between Sri Lanka and trading partners (and fully described in a confidential memorandum of understanding).

enterprises, and further substantial adjustments in wages and pensions. 1/ As a result, the overall deficit was estimated to be reduced to only 16.4 percent of GDP from 17.2 percent in 1982 and bank financing of the deficit to 1.1 percent of GDP (3.7 percent in 1982).

Additional steps were taken after March 1983 in the revenue and expenditure areas, with the result that the overall budget deficit for 1983 is to be reduced further by about 2 percent of GDP from the initial estimates and recourse of the Government to the banking system is to be limited to no more than 0.3 percent of GDP, i.e., the equivalent of 1 percent of M2 at the beginning of 1983.

The main additional effort after March 1983 to reduce the deficit has fallen on expenditure. Downward adjustments were made in the fertilizer subsidy (SL Rs 130 million) by increasing official prices by up to 26 percent in May, in interest payments (SL Rs 500 million) as a result of the reduction in the overall deficit for 1983, and in the allocations for wages and salaries (SL Rs 250 million) as a result of the freezing of the size of the civil service and the decision to shift from a monthly wage indexation system to semi-annual adjustments after September 1983. Also, on the basis of disbursements in the first half of 1983, the increase in capital expenditure in 1983 has been lowered further to 7 percent with a saving of over SL Rs 1,000 million. Against this, however, additional allocations have been budgeted to cover the losses of several state economic enterprises and for security and defense. As a result, total expenditure for 1983 has been revised downward by 5 percent (SL Rs 2,200 million) from initial estimates.

On the revenue side, the frequency of collections of the business turnover tax (BTT) has been speeded up from a quarterly to a monthly basis, and the Treasury now charges market-related interest on some advance accounts. These measures, together with the flexible exchange rate policy to be followed, are estimated to fully offset the lower receipts from the BTT on the nonmanufacturing sector due to administrative problems and from export receipts because of the unanticipated crop failures.

The 1984 budget is now under preparation. The authorities aim at a further reduction in the overall deficit to around 11 percent of GDP. It is to come about from a combination of revenue and expenditure measures, including the decision not to start any new investment projects in 1984. Given the expected continued high levels of foreign assistance, this reduction in the overall deficit would permit the Government to avoid borrowing abroad on commercial terms, as well eliminate recourse to domestic bank financing.

1/ A monthly wage increase of SL Rs 100 was granted to all employees earning less than SL Rs 1,100 per month in order to compensate for a six-month freeze of the automatic monthly cost of living allowance scheme.

c. Pricing policies

The lack of major price adjustments after mid-1981 gave rise to subsidies for certain commodities (petroleum products) and to a pronounced weakening of the overall financial position of many public enterprises. The upward adjustments in the administered prices of several commodities and in the transport fares after January 1983 were intended to correct these distortions.

The increase in the official sales prices of rice and wheat flour in early 1983 have allowed the Food Commissioner, whose operations incurred losses in 1982, to make a small profit on sales of foodgrains; the increase also allowed the Paddy Marketing Board to raise its procurement price in the first half of 1983 in order to support producer prices at a time of good paddy crops. In the case of energy prices, the adjustments made in March were substantial (ranging from 13 percent to 34 percent); they did not, however, eliminate the general kerosene subsidy, nor did they bring about the needed restructuring of relative prices of various products. The further adjustments in the prices of petroleum products made on July 20th, ranging from 12 percent for gasoline to 26 percent for kerosene, will significantly reduce the general kerosene subsidy, introduce a more rational price structure, and put the Petroleum Corporation in a profitable position. Adjustments in transport fares and in the prices of other commodities (wheat flour, rice) are to be made later in the year. Moreover, the authorities intend to pass on promptly any further rise in import costs.

d. Monetary and credit policies

During the first five months of 1983, the main developments in credit were the considerable slowdown in expansion of credit to the public sector, and the liberal credit policies, including the lowering of the discount rate in March 1983, being followed to sustain the private business recovery. In the 12 months to May 1983, credit to the private sector expanded by 32 percent but, in view of the lesser recourse to bank finance by the public sector, the growth of net domestic assets declined from 31 percent in December 1982 to 17 percent.

The Sri Lanka representatives said that the objectives of credit policies under the program were to reduce the underlying rate of inflation and improve the balance of payments while sustaining the business recovery. They noted that banks had started to increase their deposit rates again and offer more attractive deposit instruments. Largely as a result of this, they estimated that the increase in the income velocity of money observed in the first half of 1983 would be partly reversed in the second half of 1983. On this basis, and given the objective of a small overall external deficit for 1983, the Central Bank had drawn up a credit plan which features a further decline in the expansion of net domestic assets to 16 percent in the 12 months

to December 1983. Because the expansion of credit to the public sector would remain small, this would allow the provision of adequate credit to the private sector, which would expand by 24 percent in 1983. On that basis, ceilings on both outstanding net domestic assets of the banking sector and on net credit to the public sector have been established for August and November 1983 as performance criteria under the stand-by arrangement (Table 7).

In the recent past, the authorities have left commercial banks relatively free to determine their interest rate policy. This has led to a healthy competition for funds among commercial banks and the maintenance of positive real rates of interest on deposits and advances since 1981. The authorities intend to maintain this policy. The staff noted that the operations of the National Savings Bank (NSB) continued to introduce an important distortion in the financial system. The higher interest rates offered by the NSB (about 5 percentage points higher than rate paid by commercial banks for one-year deposits) and the tax advantages on deposits with it were diverting savings from commercial banks to the NSB which was a captive institution of the Treasury; this complicated the task of monetary policy, particularly since complete statistics on the NSB were available with delay and did not permit to consolidate NSB accounts in the monetary survey. Moreover, because of a mismatch of yields between its assets and liabilities, the NSB was incurring losses that were covered by budget subsidies. The Sri Lanka representatives indicated that in order to cope with the issue, the NSB deposit rates had been reduced by 2 percentage points in early 1983 and the NSB was now allowed to diversify up to 20 percent of its investment into nongovernment loans in order to improve its earning capacity.

IV. Medium-Term Outlook and Structural Policies

The medium-term economic prospects were discussed in terms of the official objectives of maintaining a rate of real growth of 5.5 percent a year in the next five years, and keeping a moderate rate of inflation but also in the light of the external constraints. While relatively moderate when compared with that of many developing countries, the present debt service burden is large considering the recent and prospective export performance. Besides, it will grow further in coming years largely because of commitments on past debt, and even under appropriate adjustment policies. The staff has estimated that the ratio of debt service payments to exports of goods and services would rise from 19 percent in 1982 to about 27 percent in 1987 and decline gradually thereafter (see Appendix Tables 13 and 14 for projections). As workers' remittances have become the second source of foreign exchange after tea exports, they can be considered as a meaningful foreign exchange resource from which external debt may be serviced. If they are added to goods and services, the debt service ratio would

reach a peak of 23 percent in 1987 (15 percent in 1982). The authorities rightly viewed this development as a potential constraint to their development strategy.

In the light of the present low level of international reserves and given the favorable prospects for external assistance, the Sri Lanka representatives said that an appropriate path for the balance of payments would be a reduction of the current account deficit from 15 percent of GDP in 1982 to 8 percent of GDP after 1985 and less in the latter part of the decade as the impact of the structural reforms will start to be felt and the bulge of the expenditures related to the Mahaweli project will diminish.

The medium-term policies embodied in the 1983-87 public investment program are designed to achieve the above objectives. The external adjustment is to come from a reduction in the investment ratio from 30 percent to 24 percent by 1987, mostly on account of a less rapid growth of public investment, accompanied by an increased domestic savings effort (Table 8). Given the inability of the two major tree crops (tea, rubber) to contribute to the growth of output in the medium term, achievement of the overall growth targets will depend upon other crops, the development of an efficient manufacturing sector, and further gains in the service sector. Achievement of the above objectives requires, however, new policies to correct the structural weaknesses of the economy. The Sri Lanka representatives stressed that the short-term stabilization of the economy envisaged in the 1983/84 program would lay a sound basis for carrying out such a strategy. Policies were being devised in such areas as investment strategy, export promotion, and domestic savings mobilization; those are discussed below.

1. Investment strategy

In recent years, the underpricing of capital relative to labor has encouraged private investment in areas that are capital- and therefore import-intensive, while the content and size of the public investment program has delayed quick-yielding or productive investments and has come at the expense of proper maintenance of existing productive assets. As noted by the IBRD, "the present public investment program has simply become too large to allow for adequate operation and maintenance spending because, as capital investments reach their stage of completion, the need for increased current spending will rise rapidly if the expected benefit of those investments is to occur." 1/

The Sri Lanka representatives indicated that the progressive reduction in the investment ratio from 31 percent to 24 percent of GDP between 1982 and 1987 was consistent with the country's absorptive capacity; it would be accompanied by a decline in the share of the

1/ Report No. 438 CE Sri Lanka: An Interim Assessment of Experience and Priorities, May 4, 1983.

public sector in total investment from the present 60 percent to 50 percent. The Government was now reviewing its medium-term investment strategy in connection with its forthcoming negotiations for a structural adjustment loan from the IBRD. More immediately, the Government had decided that the completion of ongoing projects and the maintenance of existing assets had priority in public outlays and that no new project would be started in 1983 and 1984. After expenditures on the Mahaweli project have peak in 1985, the emphasis in public investment will gradually shift toward quick-yielding and export-oriented projects (in particular in agriculture through expanded irrigation and rehabilitation of plantations) and essential infrastructure needs in power, transport, and communications, but also basic needs. The emphasis in the housing programs would shift to low-cost and self-help housing with limited recourse to the budget.

The Sri Lanka representatives justified the substantial incentives provided to private investors by the need to re-establish business confidence after 1977. However, they recognized that it was now necessary to rationalize the incentive structure. Already, the lump sum depreciation scheme had been withdrawn in 1981, tax holidays on most new investments had been discontinued after March 1983, and the 100 percent investment relief for large projects had been abolished. These measures, together with the maintenance of real positive interest rates and the flexible exchange rate policy, aimed at avoiding the underpricing of capital relative to labor and encouraging investment in sectors where Sri Lanka had a comparative advantage (agriculture, agro-based industries). The staff noted, however, that serious distortions remained in the form of high import duties that are serving to protect the domestic industry from foreign competition. Asked whether the continuing migration of skilled workers was an important constraint on economic development, the Sri Lanka representatives noted that some sectors were being adversely affected, but a steady return of trained workers to the country and the availability of intensive training programs were alleviating the shortage of skills.

The Sri Lanka representatives considered the present foreign investment code and the tax and other benefits offered to foreign investors as adequate. While there had recently been a decline in approvals of foreign direct investment, this was a reflection of the more selective official approach in approving projects in order to diversify manufacturing industries in areas other than textiles and garments which had a low value added and faced protectionism in several foreign markets.

2. External policies

The main weakness of economic developments since 1977 has been the deterioration in the external trade performance, mainly because of the failure of exports to show any significant increase in volume terms as well as diversification (Chart 2). While external factors have been important, this performance has also been the result of insufficient

incentives to producers and the general bias against exports, although this bias had been somewhat reduced over the years as seen from Chart 1. A durable improvement in the balance of payments will only come from the provision of appropriate incentives to producers of tradeables on a continuous basis--largely through maintenance of competitiveness of the exchange rate--further reductions of the anti-export bias, and the adoption of specific measures aimed at import substitution, particularly in agriculture and energy, and at export promotion.

The most striking success in import substitution has so far been in paddy. Prospects for other import substitution crops (sugar, soya, potatoes, beans) are promising, but their performance, as well as that of minor export crops (coffee, cocoa, pepper, cinnamon), has suffered from weak institutional arrangements and lack of credit facilities. The Sri Lanka representatives said that a comprehensive agricultural strategy for these crops and for livestock and fisheries was under preparation. They also noted that important foreign exchange savings could be obtained in the energy sector. Over the medium term, this would require increasing the country's hydro and low-cost thermal power generation and adoption of specific measures to encourage the efficient use of energy, particulary in industries. In the short term, energy conservation would be achieved mainly through realistic pricing policies.

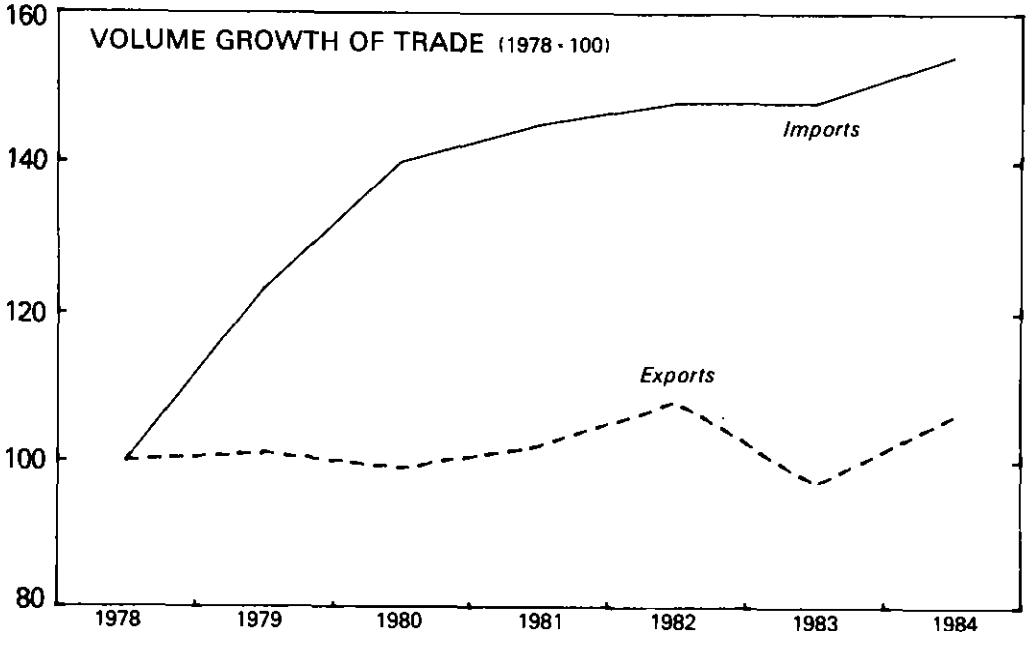
Tree crops are the backbone of the economy, but their performance has suffered as a result of neglect of plantations, in turn the result of weak management of government estates and inadequate producer margins (Chart 2). Positive producer margins have emerged in 1983, but there is a need to develop a comprehensive strategy for the sector. The two government estate companies are preparing medium-term investment plans covering specific measures to increase and diversify output, reduce costs, and upgrade quality standards. These plans, which will be ready by October 1983, will be assessed by the authorities, with the cooperation of the IBRD, for their feasibility in terms of available resources. In addition, a management consulting firm is in the process of recommending measures to strengthen accounting procedures and set up performance-related incentives for managers and workers. Implementation of these plans and recommendations is to start in 1984.

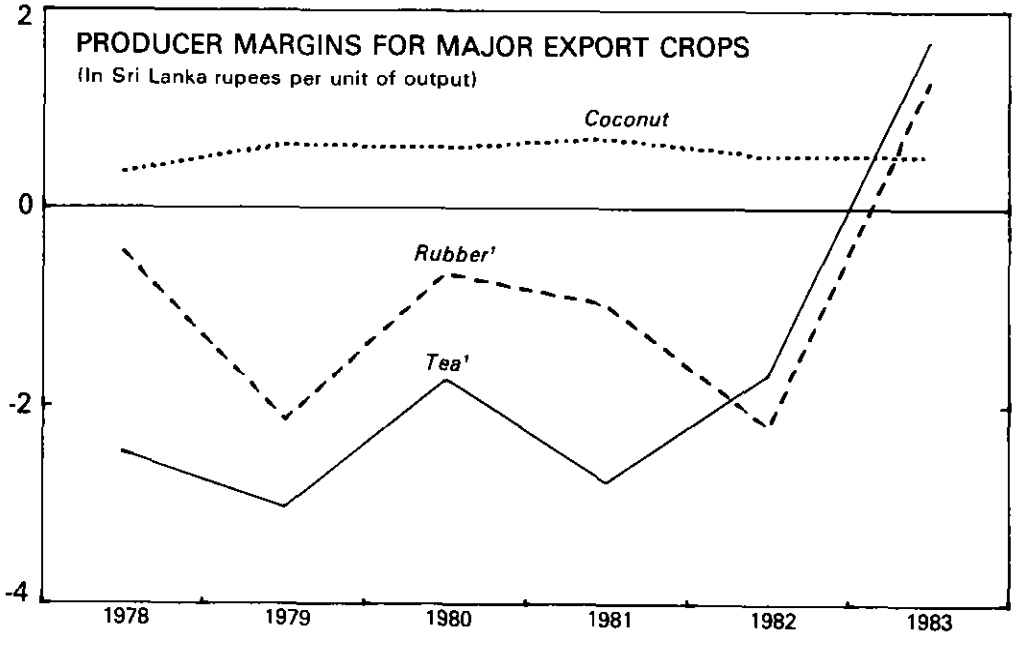
The lack of diversification of exports has been due to the existence of both high import tariffs that have led to the creation and perpetuation of inefficient manufacturing units, and of tax incentives which have favored sectors other than manufacturing. In fact, the present tariff structure is characterized by wide differences in rates that do not reflect a clear and consistent set of policy objectives; for instance, some processed agricultural commodities have negative effective protection, while many industrial commodities enjoy strong protection. The staff stressed that, as recommended by an IBRD-sponsored study, there was a need to both streamline and reduce tariff rates and that the intention of the authorities to do so included under the 1979-81 EFF program had still to materialize. The

CHART 2

SRI LANKA

FOREIGN TRADE INDICATORS





Sources: Data provided by the authorities and staff projections

[1]Data for JEDB Estates only

Sri Lanka representatives said that the above recommendations had been endorsed by the Presidential Tariff Commission and the results of the study were being updated. When the updating was completed in October 1983, the authorities would begin a phased implementation of the recommendations, with elimination of the major anomalies of the tariff rates in the 1984 budget.

3. Domestic savings mobilization

But for the rapid growth in net private transfers from abroad which offset a sagging domestic savings effort, national savings would have declined since 1977. Private savings, after rising strongly in 1977 and 1978, have decreased since to around 13.5 percent of GDP, in part as the result of the low incomes of large sections of the population and adverse terms of trade developments. Public sector savings have been consistently negative, mainly because of falling export tax receipts, the inelasticity of the tax system, and the weak financial performance of public corporations. The Sri Lanka representatives indicated that the maintenance of positive real interest rates and the further development of saving and banking habits would help increase private sector savings in the future, but the major effort would have to come from the public sector.

The staff noted that notwithstanding the tax measures of the 1983 budget, there was ample scope for a further increase in the tax effort. Indeed, the ratio of tax to GDP estimated for 1983 was still well below that achieved in 1978, as the decline in the ratio of export taxes to GDP in the period had not been offset by greater buoyancy in other taxes. The Sri Lanka representatives said that a review of the tax system had been started in 1983. Consideration was being given to levying the BTT at one single point in order to avoid cascading and make collection easier. Also, with effect from 1984, government imports would be subjected to import duty. In response to a comment by the staff that there was a need for introducing irrigation charges and appropriate pricing of inputs to farmers whose incomes are largely untaxed, the Sri Lanka representatives indicated that irrigation fees would start being charged in new land developments in the Mahaweli irrigated areas.

Improved public expenditure control will also help the public saving effort. In past years, public expenditure actuals had frequently exceeded original budget estimates, in part as a result of procedural weaknesses, but mostly because of the frequent introduction of new spendings in the course of the fiscal year. In 1982 and so far in 1983, tighter controls on cash disbursements have kept expenditures within initial allocations. This can be attributed partly to the introduction of monthly reporting and cash forecasting procedures. In early 1983, procedures to speed up foreign aid reimbursement were also strengthened. The Sri Lanka representatives said that more comprehensive means of controlling public expenditure were being devised; for instance, the charging of market-related interest rates on outstanding

advance account balances will be generalized in 1984 in order to introduce more realistic costing and greater financial discipline.

Despite steps taken in recent years to improve the operations of public corporations, the financial position of many of these units has continued to deteriorate, particularly the fertilizer factory, the railways, and the Ceylon Transport Board (CTB). Correcting the structural problems of the corporations will involve a combination of realistic pricing policies and measures aimed at tackling the chronic problems of undercapitalization and management inefficiencies. At present, the most important constraints on the public corporations' pricing policy are the formal or informal requirements for prior ministerial and/or Cabinet approval which apply in almost all cases. In this regard, the staff stressed that more frequent and modest price adjustments would help depoliticize the pricing adjustment process as well as avoid large financial losses of some of these enterprises. The Sri Lanka representatives noted that policy changes, including improved management and the termination of inefficient operations, were now being actively reviewed in the case of several enterprises. They stressed, however, the sensitivity of any solution, particularly for those corporations providing social services or selling essentials to the poorer segments of the population.

V. Staff Appraisal

The liberalization reforms started in 1977 were extensive; by now, many economic and investment decisions can be made in an environment generally free of controls. In many ways, the reforms have brought impressive results, particularly in terms of growth, improvement in infrastructure and increased employment. Since 1980, however, under the combined impact of a deterioration in the external terms of trade and expansionary financial policies, pressures have been felt on prices and the balance of payments. As a result, large-scale borrowing abroad on commercial terms was undertaken by the monetary authorities and the public sector. By early 1983, the external debt situation had deteriorated and reserves were declining toward an uncomfortably low level. Also, while the period to 1980 was characterized by the introduction of substantive structural reform, little progress in this area took place after that date.

When they introduced the 1983 budget last March, the authorities took steps in the areas of exchange rate, taxes, and pricing to redress the situation. As it became evident that these additional measures would not bring about the desired adjustment in the balance of payments, particularly in light of the impact of poor weather on production of export commodities, further measures were taken in order to contain domestic demand and strengthen the productive base for exports.

The main adjustment under the financial program which covers the 12 months to May 1984 lies in public finance where increases in revenue and a moderation of the growth of capital expenditure will permit a reduction in both the overall budget deficit and its domestic bank financing. The staff welcomes the authorities' decisions not to introduce new public investment projects in 1983 and 1984 and to move to a semi-annual wage indexation system from the previous monthly adjustments. Credit policies have been designed to meet the financing needs of the private sector within the scope of a much smaller growth of overall credit. However, the authorities should promptly tighten monetary and other policies if the inflation and balance of payments objectives appear unlikely to be reached.

The main disappointment in economic performance since 1977 has been the failure of merchandise exports to show any significant increase in volume terms and their limited diversification. The small size of the country, its lack of marketing facilities, and foreign protectionism have no doubt been important factors for this performance, but so have the neglect of the plantation sector, the high levels of tariff protection, and inadequate financial incentives. The staff therefore welcomes the commitment of the authorities to maintain the competitiveness of the tradeables sector through exchange rate flexibility. It is important, however, that exchange rate policy be closely monitored in light of the external reserve and balance of payments objectives.

The negotiated program is only a first step in the fundamental adjustment required by the situation. The resulting gains in stabilizing the economy will endure only if specific structural policies are also implemented in the areas of investment strategy, effective protection, government plantations, and savings mobilization, and if fiscal discipline can be established on a more enduring basis. It is encouraging that policies in the above areas are now being formulated. The slowdown of the public investment program will alleviate the immediate pressures on resources, as well as allow appropriate operation and maintenance of existing assets. The progress made in 1983 in preparing medium-term investment plans for the plantation sector and in devising measures to improve management and work incentives in government estates marks the first serious attempt at tackling the inefficiencies of this sector. The staff urges their early implementation. The steps taken so far to reduce the incentives to invest in capital-intensive production as well as the intention to maintain positive real rates of interest should help direct investment to sectors where Sri Lanka has a comparative advantage. Prompt implementation of the tariff reform is also needed for the creation of a more competitive manufacturing sector.

Together with the above policies, a considerable increase in domestic savings is needed if the balance of payments is to achieve viability. The main effort must fall on an improved financial position

of the public sector. The staff notes the new tax measures to be introduced in 1984 and the ongoing review of the tax system to improve its elasticity. It is also important that more comprehensive public expenditure control procedures be devised. An area of concern remains the financial situation of public corporations. The staff recognizes that the formulation of solutions to improve their operations is complex. It feels, however, that bold decisions in the pricing, management, and size of the activities of public corporations should no longer be postponed and it encourages the prompt completion of the review of policies being formulated for this sector.

There have been no changes in the foreign trade and exchange system since the last Article IV consultation. Sri Lanka maintains an exchange system which is free of any restrictions subject to approval under Article VIII. As transitional arrangements under Article XIV, Section 2, Sri Lanka maintains limitations on the availability of foreign exchange for personal travel abroad.

The staff believes that the policies described above will help achieve the objectives of the program and represent a significant step toward restoring a sustainable external position and has to be seen in the context of a multi-year adjustment effort. The staff will remain in close contact with the authorities, and a comprehensive mid-term review of the program by the Fund is to be completed by January 31, 1984. It is recommended that the next Article IV consultation with Sri Lanka be held on the standard 12-month cycle.

VI. Proposed Decisions

In view of the foregoing, the following draft decisions are proposed for adoption by the Executive Board:

(i) 1983 Consultation

1. The Fund takes this decision in concluding the 1983 Article XIV consultation with Sri Lanka in the light of the 1983 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, with the exception of certain limitations on personal travel allowances, is free of restrictions on payments and transfers for current international transactions.

(ii) Stand-By Arrangement

1. The Government of Sri Lanka has requested a stand-by arrangement in an amount equivalent to SDR 100 million for a period from , through July 31, 1984.

2. The Fund approves the stand-by arrangement attached to EBS/83/166 and waives the limitation in Article V, Section 3(b)(iii).

Fund Relations with Sri Lanka

(As of July 31, 1983)

Date of membership:	August 29, 1950
Status:	Article XIV
Quota:	SDR 178.5 million (proposed quota of SDR 223.I million under the Eighth General Review).
Use of Fund resources:	An extended arrangement for an amount equivalent to SDR 260.3 million was approved by the Executive Board on *January 26, 1979 covering a three-year* period from January 1979 to December 1981. Of the approved amount, SDR 80 million was purchased in 1979. Of the SDR 90 million available during the second year of the arrangement, SDR 30 million was purchasedd in that year. Rights to purchase were interrupted in August 1980 because of noncompliance with performance criteria. Rights were restored in June 1981, which enabled Sri Lanka to purchase the balance of SDR 150.3 million remaining under the EFF.

	(SDR millions)	(Percent of quota)
Fund holdings of Sri Lanka rupees:	481.74	269.88
Of which:		
Buffer stock	5.80	3.24
Compensatory Financing facility	38.30	21.45
Extended Fund facility	260.30	145.82
Credit tranches	4.75	2.66

Scheduled repurchases in 1983 (July 31-December 31):	SDR 9.7 million
SDR holdings:	SDR 62,152; 0.09 percent of net cumulative allocation of SDR 70.9 million.
Trust Fund loan disbursements:	Sri Lanka received loans of SDR 40.6 million from the Trust Fund in respect of the first period and of SDR 55.2 million in the second period.

Gold distribution:	83,870.981 fine ounces of gold (four distributions).
Direct distribution of profits from gold sales:	US$15.55 million
Exchange rate system:	A representative rate was established with the Fund on January 31, 1975 and adjusted on April 30, 1979 to SL Rs 1 = SDR 0.0504649. On November 16, 1977, the exchange rate was unified and the Sri Lanka rupee permitted to float at an initial rate of SL Rs 16 = US$1, representing a depreciation of 46 per cent and 11 per cent from the former official and certificate rates, respectively. The mid-rate between buying and selling rates for the Sri Lanka rupee on July 4, 1983 was SL Rs 24.20 = US$1.
Technical assistance:	In recent years, the Fund has provided technical assistance to Sri Lanka on numerous occasions. Three members of the fiscal panel have served as budget, expenditure control, and customs advisors. The Central Banking Department and the Legal Department provided assistance in drafting a new banking law as well as advice in the area of foreign exchange dealings. A resident representative has been stationed in Sri Lanka since October 1977.
Last Article IV consultation:	The Executive Board discussed the staff report on August 25, 1982 (SM/82/155).

Relations with the IBRD

(In millions of U.S. dollars)

IBRD and IDA Lending 1/	Disbursed IBRD	Disbursed IDA	Disbursed Total	Undisbursed
Agriculture	--	39.65	39.65	61.86
Industry	5.11	25.20	30.31	45.99
Irrigation	14.01	47.55	61.56	119.67
Power	58.42	9.97	68.39	89.63
Telecommunications	--	--	--	*30.00*
Transport	--	23.66	23.66	46.59
Social infrastructure	--	20.45	20.45	72.25
Program credit	--	15.00	15.00	--
Total	77.54	181.48	259.02	465.99
Payments	46.03	2.18	48.21	
Debt outstanding (including undisbursed)	69.61	607.19	676.80	
Commitments after December 1982	--	32.00	32.00	
IFC net commitment			19.03	
Latest economic mission	March 1983			
Aid Consultative Group	The last meeting was held on June 16, 1983 in Paris.			

Source: Data provided by the World Bank.

1/ As of end-December 1982.

Note: During fiscal year 1983, which has just ended, IDA committed a total of $32 million for projects in the fields of forestry and rural development. In the current year the Board has already approved $25.0 million in IDA resources for an industrial development project. During the fiscal year, it is tentatively expected to present for further Board approval projects involving about $30 million in IDA assistance and $90 million in assistance on IBRD terms, all on projects included in the public investment program.

Sri Lanka: Stand-By Arrangement

Attached hereto is a letter dated , 1983 from the Minister of Finance and Planning of Sri Lanka and the Governor of the Central Bank of Ceylon requesting a stand-by arrangement and setting forth: (a) the objectives and policies that the authorities of Sri Lanka intend to pursue for the period of this arrangement; (b) the policies and measures that the authorities of Sri Lanka intend to pursue for the period until December 31, 1983; and (c) understandings of Sri Lanka with the Fund regarding a review that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Sri Lanka will pursue for the remaining period of this arrangement. To support these objectives, policies, and measures, the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For a period from , 1983 through July 31, 1984, Sri Lanka will have the right to make purchases from the Fund in an amount equivalent to SDR 100 million, subject to paragraphs 2, 3, 4, and 5, below, without further review by the Fund.

2. Purchases under this arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 10 million until October 1, 1983, the equivalent of SDR 30 million until January 1, 1984, the equivalent of SDR 50 million until April 1, 1984, and the equivalent of SDR 75 million until July 1, 1984, but none of these limits shall apply to a purchase under the stand-by arrangement that would not increase the Fund holdings of Sri Lanka's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of Sri Lanka's currency resulting from purchases of borrowed resources beyond 12.5 per cent of quota.

3. Purchases under this arrangement shall be made from borrowed resources until purchases under the arrangement reach the equivalent of SDR 812,500, and thereafter from ordinary and borrowed resources in the ratio 2:1 until purchases under the arrangement reach the equivalent of SDR 65,312,500, and thereafter from borrowed resources only, provided that any modification by the Fund of the proportions of ordinary and borrowed resources shall apply to amounts that may be purchased after the date of modification.

4. Sri Lanka will not make purchases under this arrangement that would increase the Fund holdings of its currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of Sri Lanka's currency resulting from purchases of borrowed resources beyond 12.5 percent of quota:

(a) during any period until February 1, 1984 in which the data at the end of the preceding period indicate that

(i) the limit on net domestic assets of the banking system or the limit on net credit from the banking system to the public sector described in paragraph 15 of the annexed letter and in the table attached to it; or

(ii) the limit on contracting by the public sector or guaranteeing by the Government of external debt in the maturity range of 1-12 years or the limits on outstanding short-term debt of the banking system and of the Ceylon Petroleum Corporation presented in paragraph 17 of the attached letter and in the table attached to it; or

(iii) the understanding with regard to frequent changes in the exchange rate of the rupee as described in paragraph 19 of the attached letter,

is not observed.

(b) after January 31, 1984 until suitable performance criteria have been established in consultation with the Fund as contemplated by paragraph 20 of the attached letter, or after such performance criteria have been established, while they are not being observed;

(c) during the entire period of this stand-by arrangement, if Sri Lanka

(i) imposes or intensifies restrictions on payments and transfers for current international transactions, or

(ii) introduces or modifies multiple currency practices, or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII, or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When Sri Lanka is prevented from purchasing under this arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Sri Lanka and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Sri Lanka's right to engage in the transactions covered by this arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Sri Lanka. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Sri Lanka and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Sri Lanka, the Fund agrees to provide them at the time of the purchase.

7. The value date of a purchase under this stand-by arrangement involving borrowed resources will be normally either the 15th day or the last day of the month, or the next business day if the selected day is not a business day. Sri Lanka will consult the Fund on the timing of purchases involving borrowed resources.

8. Sri Lanka shall pay a charge for this arrangement in accordance with the decisions of the Fund.

9. (a) Sri Lanka shall repurchase the outstanding amount of its currency that results from a purchase under this arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Sri Lanka's balance of payments and reserve position improves.

(b) Any reductions in Sri Lanka's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

(c) The value date of a repurchase in respect of a purchase financed with borrowed resources under this stand-by arrangement will be normally either the 6th day or the 22nd day of the month, or the next business day if the selected day is not a business day, provided that repurchase will be completed not later than seven years from the date of purchase.

10. During the period of the arrangement, Sri Lanka shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Sri Lanka or of representatives of Sri Lanka to the Fund. Sri Lanka shall provide the Fund, through reports at intervals or dates requested by the Fund,

with such information as the Fund requests in connection with the progress of Sri Lanka in achieving the objectives and policies set forth in the attached letter.

11. In accordance with paragraph 20 of the attached letter, Sri Lanka will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 4 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Sri Lanka has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Sri Lanka's balance of payments policies.

August , 1983
Colombo, Sri Lanka

Sri Lanka - Letter of Intent

Dear Mr. de Larosiere,

1. In 1977, Sri Lanka embarked on a far-reaching economic reform which aimed at laying the foundation for rapid and balanced economic growth. This reform included the dismantling of extensive price, import, and foreign exchange controls, a retrenchment of government operations in the procurement and distribution of basic commodities, the provision of improved incentives to producers, an interest rate reform, and unification of the exchange rate system together with introduction of a flexible exchange rate policy. These reforms were successful in many respects: the rate of investment doubled between 1977 and 1982 when it reached about 30 percent of GDP; the average annual rate of economic growth has been sustained at over 5 per cent, a rate twice as high as that prevailing in the period 1970-77; paddy production has nearly doubled so that the need to import rice has virtually disappeared; and the rate of unemployment fell from 26 percent to 14 percent of the labor force as a result of the pickup in economic activity and improved employment opportunities abroad.

2. However, performance in certain other areas has been disappointing, in part due to the adverse impact of a sharp deterioration in the external terms of trade after 1979 and an unfavorable economic climate abroad. Growth in manufacturing has been slow and the performance of traditional tree crops has been adversely affected by years of neglect. At the same time, a sharp rise in public investment and other expenditures has not been matched by a corresponding increase in budgetary revenue. Notwithstanding the availability of ample concessional foreign financing, domestic financing of the budget after 1979 was large and gave rise to substantial inflationary pressures. The stagnation of traditional exports, the limited degree of success in diversifying exports, and a strong demand for imports have resulted in a widening in the external current account deficit to levels in recent years that have been considerably larger than could be financed by concessional aid inflows. As a result, the Government has had to resort to foreign borrowings on commercial terms since 1980. Even so, international reserves by end-1982 had fallen to an unacceptably low level, net reserves were negative, and the external debt profile had deteriorated. This has raised the danger that the liberal economic system adopted in 1977 might have to be abandoned in the absence of strong corrective policy action.

3. The Government is determined to correct these problems over the medium term while maintaining a satisfactory rate of noninflationary growth. The current and overall deficits in the balance of

payments since 1980 are not sustainable in the medium term, given the projected debt servicing burden and the level of external reserves, even taking account of large projected receipts of external assistance. We believe that a sustainable path for the balance of payments would be a reduction in the current account deficit (excluding official transfers) from 15 percent of GDP in 1982 to some 8-9 percent by 1986 and afterwards.

4. Substantial corrective steps to reduce the current account deficit of the balance of payments have already been taken in 1983. Starting with the introduction of the budget for 1983, the Government has embarked on a financial and economic program for which it requests assistance from the International Monetary Fund in the form of a stand-by arrangement for SDR 100 million. The main objectives of policies are to maintain a rate of real growth of 5 percent, to contain inflation to an average of 13 percent in 1983 (with a deceleration to 11 percent by December 1983 and to 8 percent by May 1984) and to reduce the current account deficit of the balance of payments to 12 percent of GDP in 1983 and further to under 11 percent in 1984. Given the constraints that the level and structure of domestic supply will impose on the growth of exports in the short run and the need for a prompt improvement in the balance of payments, the adjustment policies under the program will center on containing domestic demand. At the same time, however, significant efforts will be made to tackle the structural weaknesses of the economy.

Production and investment policies

5. The Government is determined to tackle effectively the problems of the tree crop sector, particularly in the public estates. Rehabilitation of the government estates will be a long and arduous process. To that end, an overall development strategy is being devised for the sector as a whole. Also, the two government corporations in charge of the estates are drafting medium-term investment plans aimed at increasing yields and at making efficient use of land. These draft plans are near completion and will be reviewed by the Government, in consultation with the IBRD, for their feasibility in terms of the financial resources available. Moreover, private consultants have been commissioned to recommend improvements in the management of government estates, including more appropriate forms of financial incentives for managers and workers. Progress in these programs will be reviewed with the Fund on the occasion of the mid-term review that is provided for in paragraph 20.

6. We will ensure that incentives for other agricultural production continue to be attractive. Appropriate fertilizer distribution and crop procurement schemes will continue to be operated to ensure adequate returns to producers of paddy and subsidiary crops. In this connection, the GPS price for paddy was raised in March 1983 in order to maintain incentives to paddy farmers. The price of imported wheat flour was also increased, through the imposition of an import duty and

full import costing in order to make the purchase of rice, and therefore its cultivation, relatively more attractive. It continues to be the policy of the Government to adjust food prices in order to prevent losses in the operations by the Food Commissioner, as well as to maintain adequate returns to producers.

7. It is also the Government's policy to rely more on the private sector for the production of goods and services on a commercial basis. The Government will only engage in those economic activities which, though socially necessary, are not commercially attractive or where the capital requirements are too large for the private sector to marshall on its own. Even in the case of large investment projects of a commercial nature, the Government will seek as far as possible to promote private investment while playing a catalytic role in getting them started whenever necessary. Government capital expenditure, therefore, will be concentrated on the development of infrastructure facilities essential to support investments in the productive sectors; furthermore, greater emphasis will be placed on the maintenance of existing and new facilities. The methods employed by the Government in this regard include the recent attempts to promote a capital market, to set up an equity fund, and to promote joint ventures with foreign investors. Also, policies are now geared to encourage private investment in sectors that will directly benefit the balance of payments. Some of the substantial tax benefits that encouraged capital-intensive projects have recently been removed and the Presidential Tariff Comission is updating a previous survey on tariff protection. This survey should be ready by October 1983. The recommendations will be progressively implemented; basically, the anomalies in import tariff rates would first be corrected and the changes in tariff rates that would follow would make Sri Lankan industries more efficient and internationally competitive. Some of the measures are to be implemented in the 1984 budget. Progress in the implementation of the recommendations will be part of the mid-term review of the progam.

8. Since 1977, the Government has attached high priority to promoting investment in order to sustain a high rate of economic growth. Generous incentives have been provided to both domestic and foreign private investors. In addition, the public sector embarked on an accelerated public investment program which included the Mahaweli hydropower and irrigation project and other infrastructure investments. These incentives and programs have worked well and have brought many benefits to the Sri Lanka economy. However, the rapid pace of investment has placed severe pressure on human, physical, and financial resources. The Government has, therefore, decided that public investment policy from 1983 onwards will be made more compatible with the available resources as well as with the need to improve the balance of payments. The focus of public investment policy in the short term is on the completion of ongoing projects, most of these being largely foreign-financed. For that purpose, no new project besides those already included in the plan is to be introduced in 1983 or 1984. Moreover, we shall review the medium-term public investment strategy

with a view to ensuring that public investment is compatible with the absorptive capacity of the economy and the country's savings effort and that it is directed to increasing production, particularly through the rehabilitation of existing productive assets. This would imply that the ratio of public investment to GDP will decrease below the projected 1983 level in the years to come, a development that is necessary to ensure that sufficient budgetary resources are devoted to the maintenance of existing assets. A careful review of the investment strategy will be an element of the mid-term review of the program by the Fund.

Energy policy

9. Energy policy has focused in recent years on harnessing domestic hydropower resources through the building of power generation facilities as part of the Mahaweli project, the first part of which is to become operational in late-1984. This policy of diversification of energy sources will contribute to containing Sri Lanka's dependence on external sources of energy from the mid-1980s.

10. Energy demand in recent years has grown by about 8 percent a year, and the energy import bill has grown as a share of imports and GDP. This development has highlighted the need for energy conservation and efficient energy use through rational pricing policies and other incentives. To that end, the prices of petroleum products were increased by 13-50 percent in early March 1983. Recent developments have necessitated further increases in prices of petroleum products. Task forces have been set up by the Ministry of Power and Energy in 1983 to integrate the efforts by government agencies in conserving and using energy efficiently. An Energy Conservation Fund was set up in early 1983 to encourage the private sector to invest in energy-saving equipment.

Budgetary policies

11. Budgetary policies in 1983 focus on raising the revenue effort and restraining the growth in public capital expenditures. Further steps have recently been taken and the overall budget deficit will be reduced to SL Rs 16.0 billion in 1983, implying a large reduction in terms of GDP. The deficit is to be financed to the extent of SL Rs 12 billion by foreign financing, the bulk of it in the form of grants and concessional loans. Recourse to domestic financing will be reduced to SL Rs 4 billion of which SL Rs 0.3 billion will be from the banking system. The 1984 budget is presently under preparation. We intend to further reduce the overall deficit to around 11 per cent of GDP in that year, which will require little or no recourse to bank financing. We intend to achieve this further improvement in the budget through a combination of revenue measures and strict expenditure restraint.

12. The lack of buoyance of the tax system and the discretionary reductions in export taxes since 1979 have weakened the domestic

revenue effort in recent years. To reverse this trend several new tax measures were introduced in February 1983, including a rise from 2 percent to 4 percent in the BTT rates, increases by 2.5-5.0 percentage points in most import duties, and the introduction of import duties on previously exempted items (with the exception of government imports). These measures are projected to increase budget revenue significantly, thereby reversing the declining trend in the tax revenue that will increase by over 2 percent of GDP in 1983. In addition, effective April 1983, tax holidays are no longer granted to new investment projects except to those in export industries. We are now undertaking a general review of the tax system with the aim of improving its buoyancy.

We are giving consideration to simplifying the BTT structure and improving its collection. Government imports will be subjected to import duty in 1984. Progress in implementation of the tax reform will be assessed on the occasion of the mid-term review of the program.

13. We intend to limit the growth of total public expenditures to 19 percent in 1983. The main developments are a rapid increase in interest payments, the revision of the wage indexation scheme, and an increase of 7 percent in capital expenditure, implying a reduction in real terms. In order to reduce an important rigidity in public finance the monthly wage indexation has been abandoned and transformed into half-yearly adjustments. In March 1983, a wage increase of SL Rs 100 per month was awarded to lower-paid civil servants and other public servants, and the cost of living adjustment was frozen, subject to review after a six-month period. We intend to cover any further increase in the wage bill that may result from the September review by existing budget provisions. We have also decided that there would be no hiring of new employees in 1983 other than to fill vacancies and to ensure implementation of the public investment program. As regard subsidies to households, the food stamp scheme has remained stable in rupee terms in 1983, but the fertilizer subsidy has been reduced as a result of an increase in fertilizer prices in June. We have strengthened procedures governing financial advances to public bodies (through advance accounts) and from 1984 market-related interest rates will be charged on outstanding advance accounts with a view to steadily reducing the outstanding balances, and in order to encourage proper costing in public enterprises. As regard capital expenditure, we have decided that no new unplanned project would be started in 1983 and 1984. Because a main source of imbalance in public finance in the past has been the inadequate control of public expenditure, several steps have been introduced in 1982 and 1983 to improve expenditure discipline, including a tightening of cash disbursements. We are working to develop more comprehensive and effective systems of expenditure control.

14. The performance of public corporations is a source of serious concern to the Government, in particular the large financial deficits

experienced by several of them. The major reasons for the poor performance are their undercapitalization, weak management, and lack of price flexibility. We are at present considering ways to remedy the situation. While in some cases greater pricing flexibility will help, in other cases more substantial policy changes are required, including the termination of inefficient operations. Several official prices and service rates were raised in early 1983 (wheat flour, rice, petroleum products, bus and railway fares, etc.) and consideration is being given to further adjustments in the near future in order to improve the financial situation of some corporations.

Monetary policies

15. The main objectives of monetary policy during the program period will be to support the external adjustment, contain inflation, and provide adequate financing to the productive sectors, particularly of exports. Already a substantial deceleration in the increase in net domestic assets has taken place in 1983. Consistent with a projected 5 percent growth rate and an expected rise in prices of 11 percent through 1983, broad money is expected to grow by 15 percent, implying broadly unchanged velocity from 1982. Taking into account this demand for liquidity and a planned balance of payments deficit of SDR 13 million for 1983 as a whole, the expansion of net domestic assets of the banking system should be in the order of no more than 16 per cent in 1983. Within the total, credit to the public sector should grow by no more than 3.8 percent, leaving ample scope for sufficient credit to the private sector to finance its genuine needs for expanded activity, particularly in the export sector. Consistent with this credit policy, quarterly credit ceilings have been set, as in the attached Table 1. These ceilings may be adjusted automatically to any decline beyond the projected path in any component of net domestic assets that is beyond the control of the authorities and could not be construed as being equivalent to an increase in domestic credit. If it should appear that the balance of payments objective is not being achieved appropriate action will be taken.

16. In order to encourage private savings mobilization and the efficient use of capital, financial institutions have been left relatively free to determine their interest rate policy. As a result, interest rates on one- and two-year deposits with commercial banks have been positive in real terms and we intend to maintain this policy.

External policies

17. Our policies aim at reducing the current account imbalance to a level compatible with Sri Lanka's financing capacity while maintaining a trade and payments system free of restrictions. On the basis of present expectations regarding the future growth of the economy and export earnings, and the availability of foreign financing, we aim at lowering the current account deficit to 12 per cent of GDP in 1983 and further to about 10 percent in 1984. The current account deficit in

1983 will be financed largely by foreign aid in the form of grants and loans. Overall, the balance of payments is projected to record a deficit of SDR 13 million and gross official reserves are projected to be equivalent to about two months of imports by year-end. In order to limit the burden of external debt service in the future, our policy is to restrain recourse by the public sector to commercial borrowings abroad. Consistent with this policy, the contracting by the public sector or guaranteeing by the Government of foreign loans on commercial terms in the maturity range of 1-12 years will not exceed the equivalent of SDR 50 million in the period June 1 to November 30, 1983. Short-term external debt shall not exceed the limits shown in Table 2. Limits for the remainder of the program period will be set on the occasion of the mid-term review of the program. As far as lending by FCBUs to domestic residents, we are undertaking a study with the assistance of the IBRD and the Commonwealth Secretariat to devise appropriate debt management methods.

18. In 1983, the tightening of financial policies will help to moderate the demand for imports. However, the major thrust of our medium-term external policies for balance of payments improvement is the promotion of exports. We have already implemented several measures in 1983 such as increased replanting subsidies for rubber and tea, lower export tax rates, the introduction of an exchange rate policy that provides adequate incentives, new refinancing facilities for non-traditional exporters and the maintenance of tax concessions for the export sector. Over the medium term, export growth will come from the rehabilitation of traditional export crops and the development and diversification of other exports, including encouragement of tourism. Besides the action program for the plantation sector described above in paragraph 5, we have also embarked on an exercise to develop a comprehensive agriculture, food, and nutrition strategy that should help identify priority areas for development within this broad sector, which includes crop cultivation and animal husbandry as well as fisheries. New ways to reduce some of the constraints on exporters (e.g., lack of market knowledge or of adequate technology) are also being actively explored; in particular, foreign participation in export ventures is being encouraged. We also consider that an improvement in the external accounts can come from import substitution through the encouragement of various promising crops (beans, sugar) as well as efficient energy policies.

19. The authorities are committed to implementing a flexible exchange rate policy. The exchange rate of the Sri Lanka rupee was changed from SL Rs 21.4 per U.S. dollar at end-1982 to SL Rs 22.9 per U.S. dollar in February and further to SL Rs 24.20 on July 4, 1983. Thereafter, the exchange rate of the Sri Lanka rupee will be adjusted frequently on the basis of the price performance of Sri Lanka relative to its major trade partner countries, in order to at least maintain the competitiveness of the rupee.

20. The Government of Sri Lanka believes that the policies set forth in this letter are adequate to achieve the objectives of its program, but will take any further measures that may become appropriate for this purpose. The Government will consult with the Fund on the adoption of any such measures, in accordance with the policies of the Fund on such consultation. The Government of Sri Lanka will review developments under the program and the progress achieved in the implementation of the structural policies described in paragraphs 5, 7, 8, and 12, and will reach with the Fund before January 31, 1984, understandings regarding the Government's budgetary, exchange rate, and external borrowing policy as well as the quantitative performance criteria referred to in paragraphs 15 and 17 for the remaining period of the stand-by arrangement.

Yours sincerely,

W. Rasaputram
Governor
Central Bank of Ceylon

Ronnie de Mel
Minister of Finance
and Planning

Attachment.

Mr. J. de Larosiere
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Table 1. Sri Lanka: Limits on Net Domestic Assets and on Net Credit to the Public Sector by the Banking System

(In millions of Sri Lanka rupees)

	Limits on	
	Net domestic assets	Net credit to the public sector
August 31, 1983	34,500	22,000
November 30, 1983	36,000	22,300

Table 2. Sri Lanka: Limits on Short-Term Debt

(In millions of SDRs)

	Limit on Outstanding Short-Term Debt 1/
May 31, 1983 (actual)	277
August 31, 1983	325
November 30, 1983	301

1/ Defined to include short-term foreign borrowing by the Central Bank, commercial banks, and Ceylon Petroleum Corporation.

Table 9. Sri Lanka: External Debt Disbursed, 1979-82

(In millions of SDRs)

		1979	1980	1981	1982
I.	External debt outstanding (end of period)	1,099	1,437	1,987	2,498
	a. Medium- and long-term	1,081	1,285	1,820	2,240
	Government and government guaranteed	843	1,037	1,393	1,778
	On concessional terms	(806)	(947)	(1,144)	(1,308)
	On commercial terms	(37)	(90)	(249)	(470)
	Private nonguaranteed	3	37	81	120
	FCBUs	(2)	(33)	(62)	(93)
	Other	(1)	(4)	(19)	(27)
	Use of Fund resources	235	211	346	342
	b. Short-term	18	152	167	258
	Public sector	1	131	142	190
	Commercial banks	17	21	25	68
II.	Debt service	110	126	189	235
	a. Principal repayments on long-term debt	73	81	96	124
	Of which: Fund repurchases	(27)	(33)	(54)	(45)
	b. Interest payments	37	45	93	111
	On medium- and long-term debt	35	36	65	80
	Of which: Fund charges	(11)	(12)	(16)	(22)
	On short-term debt	2	9	28	31
III.	Memorandum items:				
	Debt service ratio	12	12	16	19
	External debt outstanding as percent of GDP	42	46	53	57
	Share of short-term debt in total debt (in percent)	1.6	10.6	8.4	10.3

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

Table 10. Sri Lanka: Summary of the Financial Program

	1982 Actual	1983 Program	1984 Program
		(Percentage changes)	
I. Assumptions			
Real GDP growth	5.1	4.6	5.5
Nominal GDP growth	17.8	18.2	15.0
Export volume	2.8	-5.4	12.3
Export prices (SDR terms)	1.0	10.8	3.5
Terms of trade	7.4	16.8	0.8
II. Targets			
a. Inflation	11	13	8
b. Balance of payments			
Current account deficit			
(In mn. SDRs)	668	570	523
(As % of GDP)	15.3	12.2	10.5
Overall balance			
(In mn. SDRs)	-24	-13	21
c. Public sector finances			
Overall budget deficit			
(In mn. SL Rs)	17,248	-17,500	...
(As % of GDP)	17.2	14.6	11.0
Domestic bank financing			
(In mn. SL Rs)	3,755	300	--
(As % of GDP)	3.7	0.3	--

III. Principal policy elements

1. External policies: A 5 per cent depreciation of the rupee against the U.S. dollar was effected on July 4, 1983, and a flexible exchange rate policy is to be followed thereafter aimed at preventing any appreciation of the real effective exchange rate.

   Imports will be restrained through increased import duties and a slowdown in government expenditure and private credit.

   Limits have been placed on new contracting of nonconcessional external public debt and government guaranteed debt in the maturity range of 1-12 years as well as on the amount of certain outstanding short-term debts.

Table 10 (concluded). Sri Lanka: Summary of the Financial Program

2. Budgetary policies: Reduction of the overall budget deficit in 1983 and virtual elimination of the Government's recourse to the banking system. The main measures are increases in BTT rates and import duties and restraint on capital expenditure growth. Further reduction of budget deficit in 1984 to 11 per cent of GDP through additional revenue and expenditure measures, including tighter control on advance accounts.

3. Monetary policy: Moderation in the rate of credit expansion, consistent with the program objectives.

   Maintenance of positive real interest rates.

4. Pricing policies: Increases in administered prices of petroleum products, transport fares, fertilizer, flour, rice, and milk products in early 1983 and further increases in prices of petroleum products in July 1983.

   Flexible pricing policy during program period, including full passthrough to domestic prices of higher import costs due to exchange rate changes.

5. Wages: Discontinuation of the monthly wage indexing system during March-September 1983 and replacement by a semi-annual scheme after September 1983.

   Limited growth of employment in the public sector.

6. Exchange and trade system: Standard understandings pertaining to exchange restrictions, multiple currency practices, bilateral payments, and balance of payments related restrictions on imports will cover the program period.

7. Structural adjustment policies: Undertaking to complete studies and initiate implementation of recommendations to correct structural weaknesses in the following areas: public investment strategy; state plantations; effective protection; and tax reform.

8. Others: Mid-term review by the Fund no later than January 1984 of progress under program.

Table 11. Sri Lanka: Value, Price, and Volume Indices for Imports and Exports, 1981-83

(1980 = 100)

	1980	1981	1982	1983	1984 1/
Value indices (in SDR terms)					
Total imports	100	101	116	112	119
(Excluding petroleum)	(100)	(96)	(108)	(111)	(121)
Total exports	100	110	114	119	136
Traditional	(100)	(103)	(95)	(103)	(111)
Other	(100)	(122)	(139)	(139)	(168)
Price indices (in SDR terms)					
Total imports	100	107	101	96	98
(Excluding petroleum)	(100)	(102)	(93)	(92)	(94)
Total exports	100	101	102	113	117
Traditional	(100)	(97)	(89)	(109)	(108)
Other	(100)	(108)	(116)	(118)	(125)
Volume indices					
Total imports	100	94	115	116	121
(Excluding petroleum)	(100)	(94)	(115)	(119)	(121)
Total exports	100	109	112	106	119
Traditional	(100)	(106)	(106)	(94)	(103)
Other	(100)	(114)	(123)	(121)	(143)
Memorandum item:					
Terms of trade index	100	94	101	118	119

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

1/ Program forecast.

Table 12. Sri Lanka: Revenue and Expenditure Measures in the 1983 Budget 1/

	Description of Measure
I. Revenue	
a. General sales and turnover tax	The basic rate was raised from 2 to 4 per cent, and other rates by 2.5 to 5 percentage points.
b. Import duty	All hitherto duty free imports were made subject to a 5 per cent duty rate while existing rates were increased by 2.5 to 10 percentage points.
c. Export duty on tea	The taxable threshold was raised from SL Rs 22 to SL Rs 26 per kg.
d. Trading enterprises	Increases in bus fares by 25 per cent and train fares by 40 to 48 per cent. Also, the prices of petroleum products, milk, rice, and wheat flour were increased.
e. Company income tax	All tax holidays other than those approved by March 31, 1983, were abolished, with the exception of nontraditional exports that will enjoy a five-year tax holiday.
f. Advance accounts	Effective February, market related interest rate is charged on some advance accounts.
II. Current expenditure	
a. Wages and salaries	Salaries of all civil servants, local government employees, and pensioners under SL Rs 1,100 were increased by SL Rs 100 per month and the monthly automatic wage indexation scheme was discontinued for six months.
b. Subsidies	(1) The value of kerosene stamps was increased by 63 per cent. (2) The subsidy to the Milk Board was reduced by SL Rs 25 million. (3) The Export Development Board was allocated SL Rs 250 million for export grants. (4) Replanting subsidies were increased by SL Rs 2,000 per acre for tea and SL Rs 1,500 for rubber. (5) An Energy Conservation Fund was set up with a SL Rs 5 million allocation. (6) Fertilizer prices were raised involving a a reduction in the subsidy. (7) Interest rates on time deposits with the NSB were reduced thereby reducing the subsidy to the NSB by SL Rs 145 million.
III. Capital expenditure	No new projects are to be started in 1983 and 1984.

1/ Some of these measures were introduced in February while others were introduced after the budget approval in late March 1983.

Table 13. Sri Lanka: Balance of Payments, 1983-90

(In millions of SDRs)

	1983	1984	1985	1986	1987	1988	1989	1990
Trade balance	-792	-764	-698	-628	-567	-547	-620	-644
Exports	971	1,111	1,220	1,345	1,480	1,645	1,790	1,970
Imports	1,763	1,875	1,918	1,973	2,047	2,192	2,410	2,614
Services (net)	-41	-49	-74	-87	-78	-68	-65	-56
Receipts	327	362	400	420	440	460	480	500
Payments	368	411	474	507	518	528	545	556
Interest	(133)	(161)	(194)	(219)	(223)	(230)	(235)	(241)
Other	(235)	(250)	(280)	(288)	(295)	(298)	(310)	(315)
Private transfers (net)	263	290	310	315	320	325	330	335
Current account	-570	-523	-462	-400	-325	-290	-355	-365
Official transfers	150	160	160	160	160	170	170	170
Non-monetary capital	407	384	350	318	251	219	265	265
Overall balance	-13	21	48	78	86	99	80	70
Gross official reserves	25	-69	-12	-10	-15	-25	-20	-20
Use of Fund resources	-17	48	-36	-68	-71	-74	-60	-50

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

Table 14. Sri Lanka: External Debt Service, 1983-90

(In millions of SDRs)

	1983	1984	1985	1986	1987	1988	1989	1990
I. On debt disbursed at the end of 1982								
a. Midium- & long-term								
Government and governmnet-guaranteed	157	168	174	207	228	226	184	139
Interest	(67)	(73)	(68)	(74)	(64)	(60)	(53)	(43)
Amortization	(90)	(95)	(106)	(133)	(164)	(166)	(131)	(96)
IMF	64	42	54	73	63	53	46	34
Charges	(17)	(20)	(18)	(25)	(12)	(9)	(6)	(4)
Repurchases	(47)	(22)	(36)	(58)	(51)	(44)	(40)	(30)
Private nonguarangeed	16	15	24	22	21	20	20	16
Interest	(10)	(8)	(8)	(8)	(7)	(5)	(4)	(2)
Amortization	(6)	(7)	(16)	(14)	(14)	(15)	(16)	(14)
b. Short-term (ineterest)	29	31	33	33	33	33	33	33
CPC	(12)	(14)	(15)	(15)	(15)	(15)	(15)	(15)
Other	(17)	(17)	(18)	(18)	(18)	(18)	(18)	(18)
II. On new debt								
Medium- and long-term								
Concessional loans								
Interest	3	6	15	21	26	31	36	41
Amortization	--	--	--	--	--	--	--	--
Commercial loans								
Interest	6	16	42	59	73	86	100	117
Amortization	4	8	28	23	44	65	91	116
IMF								
Charges	1	7	10	9	8	6	3	1
Repurchases	--	--	--	10	20	30	20	20
III. Total debt service	280	293	380	457	516	550	533	517
Interest	133	161	194	219	223	230	235	241
Amortization	147	132	186	238	293	320	298	276
Total debt service as per cent of:								
Exports of goods and services	21.6	20.9	23.5	25.2	26.9	27.1	23.5	20.9
Current account receipts	17.9	17.3	19.7	22.0	23.1	22.6	20.5	18.4

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

Table 15. Sri Lanka: Selected Economic and Financial Indicators

	1980	1981	1982	1983 Estimate	1984 Proj.
	(Annual percentage change unless otherwise specified)				
National income and prices					
Real GDP	5.8	5.8	5.1	4.6	5.5
GDP deflator	20.0	20.8	12.1	13	8
Consumer prices (end of period)	28.2	23.5	1.4	12.8 1/	...
(Administered prices)	(49.2)	(15.3)	(-5.2)	(7.8) 1/	(...)
Consumer prices (average)	37.7	23.7	11.0	13.0	8
External sector (on the basis of SDRs)					
Exports	7.8	11.0	2.9	4.0	14.4
Imports	40.6	1.0	14.7	-3.5	6.4
Non-oil imports	29.6	-3.6	12.0	2.5	3.8
Export volume	-1.0	9.0	2.8	-5.4	12.3
Import volume	7.5	-6.0	22.3	0.9	4.3
Terms of trade	-15.0	-6.0	7.4	16.8	0.8
Nominal effective exchange rate (depreciation = -)	-17.3	-3.5	5.4	-10.3 2/	...
Real effective exchange rate (derpeciation = -)	-3.4	10.5	-3.0	-2.9 3/	...
Government budget					
Revenue	10.3	15.1	8.9	36.7	...
Total expenditure	48.7	-0.2	18.8	18.7	...
Money and credit					
Net domestic assets	70.8	26.7	31.2	15.9	...
Public sector	109.7	31.4	26.1	3.8	...
Private sector	57.7	34.0	24.0	23.0	...
Broad money	31.8	23.2	24.6	14.9	...
Velocity	3.38	3.50	3.31	3.42	...
Interest rate (12-month time deposits)	20.0	20.0	15.0	15.0 3/	...
	(In per cent of GDP)				
Budget					
Overall budget deficit	-23.1	-15.6	-17.2	-14.6	-11.0
Revenue	19.9	17.9	16.6	18.9	...
Expenditure	43.0	33.5	33.8	33.5	...
Domestic bank financing	10.6	4.5	3.7	0.3	--
Foreign financing	9.2	8.9	8.1	10.0	...
External sector					
Current account	-19.8	-13.3	-15.3	-12.2	-10.5
External debt (including use of Fund credit)	46.3	53.0	56.7	68.0	...
Debt service ratio 4/	12.2	16.2	19.1	21.6	20.9
Interest payments 4/	4.4	8.0	9.0	10.2	10.9
	(In millions of SDRs)				
Current account deficit	-613	-502	-668	-570	-523
Overall deficit	-166	-26	-24	-13	21
Gross official reserves	193	289	313	288	357
(In months of imports)	(1.5)	(2.2)	(2.1)	(2.0)	(2.1)

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

1/ Twelve-month period ended June 1983.

2/ December 1982-July 1983.

3/ December 1982-April 1983.

4/ In per cent of goods and services.