

EBS/83/166
Supplement 1

CONFIDENTIAL

September 7, 1983

To: Members of the Executive Board

From: The Secretary

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

The attached supplement to the staff report for the 1983 Article IV consultation with Sri Lanka and its request for a stand-by arrangement has been prepared on the basis of additional information. This subject has been tentatively scheduled for discussion on Wednesday, September 14, 1983.

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) or Mr. Gollé (ext. (5)7325).

Att: (1)

INTERNATIONAL MONETARY FUND

SRI LANKA

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

Prepared by the Asian Department
and the Exchange and Trade Relations Department

Approved by Tun Thin and Donald K. Palmer

September 7, 1983

Severe disturbances took place in Sri Lanka in the week starting July 23rd. These were the result of conflicts between various ethnic groups and included disruption and looting of industrial, commercial and residential property. This supplement is based upon the findings of a staff mission ^{1/} that visited Colombo during August 27-30, 1983, in order to: (i) assess the economic effects of the disturbances; (ii) provide the most up-to-date information on economic developments and policies; and (iii) on this basis, assess whether the policies under the negotiated program supported by the proposed stand-by arrangement are still consistent with the adjustment objective.

1. Impact of the disturbances on productive assets

Agriculture was largely unaffected by the disturbances. The major impact has fallen on urban areas where numerous houses, small shops, and some private sector industrial factories have been damaged. As a result, about 100,000 people have been displaced, but they are being gradually resettled.

Following the disturbances, the Government set up the Rehabilitation of Property and Industrial Authority (REPIA) under which all property affected by the riots was vested in the State retroactively as of July 23, 1983; the purpose was to ensure that damaged buildings and property would not be forcibly occupied by squatters or disposed of through distress sales. The authorities have indicated that property vested in REPIA would be returned to the former owners and such divesting has already taken place for several large industrial units. Rehabilitation of damaged property may, in cases where sufficient finance is not available from private sources, involve equity participation by the Government or public sector agencies.

^{1/} The mission consisted of Messrs. Chabrier (ASD), Paljarvi (ETR), Ahmed (IBRD), and was assisted by Mr. Mountford, the Fund resident representative in Sri Lanka.

A Government Task Force has estimated that industrial establishments in the greater Colombo area, employing a total of 15,000 persons, had been damaged or destroyed. Of the 116 establishments assessed by the Task Force, 10 could be made immediately operational, 19 could be operational within a month, and 55 in about six months. Only 28 units were fully destroyed. The replacement value of the destroyed machinery, plant and equipment was estimated at SL Rs 1,750 million (1.5 percent of GDP). The industrial sectors most affected have been synthetic textiles and garments where the respective production losses for 1983 are estimated at 20 percent and 15 percent. Other sectors which have suffered significant damage are asphalt, cosmetics, coconut processing, PVC pipes, and cartons and paper. Overall, it is estimated that total unemployment resulting from the disturbances is about 30,000 (i.e., 0.5 percent of total employment).

The Task Force is recommending that less affected industries or those that can be reconstructed with their own funds be divested quickly from REPIA to their former owners and that the Government expedite insurance claims and credit requirements, particularly in the case of export industries. In the case of fully destroyed factories, it recommends an in-depth reappraisal of their operations. The reconstruction of industries where excess capacity exists in the sector and of those with low or negative value added which have relied on considerable protection in the past, should be discouraged. Rehabilitation of export industries and of those with a high value added or that serve a basic need of the population (food, clothing, etc.) should be given priority. These recommendations have been endorsed by the Ministry of Finance and are being considered by the Cabinet.

2. Recent domestic economic developments

As a result of production losses in the affected sectors, and of the adverse impact on tourism and construction, the authorities estimate that GDP will grow by about 4 percent in 1983 as against the earlier forecast of 4.6 percent under the program. Under the present circumstances, investors have adopted a cautious attitude, while consumers have kept their purchases of less essential items to a minimum.

The COL index of the Central Bank which was 9.5 percent higher in May 1983 than in May 1982 increased further and was 12.3 percent higher in July 1983 than in the corresponding month of 1982. The main factor responsible for the acceleration was the adjustments in the administered prices of several goods and services; the index of administered items was 22.3 percent higher in July 1983 than in July 1982. The increase in nonadministered prices has also accelerated in recent months (10.7 percent in the 12 months to July) reflecting in part exchange rate adjustments. The wholesale price index (excluding commodity export items) fell between May and June but was 9.6 percent higher than in June 1982.

A notable feature has been the success of the Government and the free trading system in distributing essential items during and after the disturbances. The availability of ample stocks of rice procured earlier by the Paddy Marketing Board, the new sales facilities offered to rice traders by the Ministry of Trade, and the disposal of inventories, caused food prices to return at or below their July levels by mid-August following a brief burst of inflation during the disturbances. As a result, the authorities estimate that the price developments in 1983 will be broadly in line with that assumed under the negotiated program.

The authorities have continued their flexible pricing policy. In August, bus fares were raised by amounts ranging from 50 percent-100 percent, railway passenger fares and freight rates by amounts ranging from 10 percent-30 percent, and the electricity tariff surcharge applied to heavy users during peak period from 110 percent to 185 percent of the basic rate.

3. Fiscal policy

The overall budget deficit for FY 1983 is not expected to be affected much by the consequences of the recent civil disturbances, as a larger than planned current account deficit should be largely offset by a slow-down in capital expenditures. Preliminary adjustments to the main budget aggregates are shown in Table 1.

On the revenue side, the authorities expect a shortfall of about SL Rs 1,500 million (7 percent) from earlier estimates as a result mainly of reduced BTT collections due to a slow-down in trading activity, and deferment of some income tax liabilities for those in financial difficulties. Increased allocations for security and for provision of food and other emergency relief for displaced persons are estimated at some SL Rs 150 million, but can be met out of existing contingency allocations. Some additional expenditures through the so-called Advance Accounts will occur as a result mainly of the need for the Food Commissioner to rebuild stocks of paddy and other essential foodstuffs depleted in the immediate aftermath of the crisis. Strict financial discipline is being enforced by the Treasury with respect to other expenditures. It is estimated that total current expenditures may exceed the original budget allocation by only some SL Rs 200 million (0.9 percent).

Most of the increase of SL Rs 1,700 million in the current deficit of the budget is expected to be offset by a slow-down in capital disbursements. Work on some development projects has stopped and the pace of activity on others has slowed down considerably, largely as a consequence of the departure of skilled workers. As a result, the overall budget deficit is expected to rise only marginally from SL Rs 17.5 billion to SL Rs 17.8 billion.

Table 1. Sri Lanka: Central Government Budget, 1981-83

	1981	1982 Prov.	1983		
			Original budget	Program estimates	August estimates
(In millions of Sri Lanka rupees)					
Revenue	15,259	16,610	22,710	22,700	21,200
Total expenditure	28,498	33,858	42,412	40,200	39,000
Current	16,741	18,024	24,446	23,300	23,500
Capital	11,757	15,834	17,966	16,900	15,500
Overall deficit	-13,239	-17,248	-19,702	-17,500	-17,800
Foreign financing (net)	7,602	8,121	12,606	12,050	11,950
Concessional aid	5,902	6,896	10,776	10,685	10,200
Commercial borrowings	1,700	1,225	1,830	1,365	1,750
Exceptional transfer <u>1/</u>	--	--	1,500	1,500	1,500
Domestic financing	5,637	9,127	5,596	3,950	4,350
Nonbanks	1,790	5,372	4,235	3,650	3,850
Banks	3,847	3,755	1,361	300	500
(As a percent of GDP)					
Revenue	17.9	16.6	18.9	18.9	17.7
Total expenditure	33.5	33.8	35.3	33.5	32.5
Overall deficit	15.6	17.2	16.4	14.6	14.8
Concessional foreign aid	6.9	6.9	9.0	8.9	8.5
Foreign commercial borrowings	2.0	1.2	1.5	1.1	1.6
Domestic financing <u>2/</u>	6.6	9.1	5.9	4.6	4.8
Bank financing	4.5	3.7	1.1	0.3	0.4

source: 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.

A reduced disbursement of foreign concessional assistance (due to the slow-down in project activity) will be in part offset by higher recourse to foreign commercial borrowing, in the form of a further draw-down of a Eurodollar loan facility arranged in 1982. As a result, the authorities expect to be able to contain recourse to bank-financing by the budget to SL Rs 500 million (as against SL Rs 300 million in the previous estimates and a recourse of SL Rs 3,755 million in 1982).

Preparations for the 1984 budget are under way. Although they have been rendered more difficult by the economic uncertainties following the July disturbances, the budget will be presented at its normal time in mid-November 1983. It is expected that the 1984 budget will be largely in line with the policies enunciated earlier. Revenue from BTT may again be adversely affected by a somewhat lower level of domestic activity, but the authorities are considering additional measures to boost revenue. Expenditures on rehabilitation and relief will require an increase in some categories of expenditure, but it is expected that reconstruction of housing, especially, will occur slowly and after some delay. Any worsening in the current account, however, is likely to be more than offset by lower expenditures on capital account; it is expected that a continuing shortage of skills, and other consequences of the recent disruptions, will result in a much higher than usual degree of underfulfillment of development projects.

4. Monetary policy

The broad aims of credit policy remain the same as formulated in connection with the financial program. The authorities expect to be able to keep credit within the ceilings set under the program. In the months to come it is expected that the sectoral distribution of credit will shift in response to the changed economic environment. It is not yet clear to what extent the industrial sectors that have been directly affected by riot damage will seek resources from the banking sector to finance rehabilitation and the restarting of operations, rather than relying on self-financing or government assistance. The main aim of credit policy in this regard will be to give priority to sectors which directly or indirectly contribute to exports. Credit will not be readily available to nonpriority sectors such as consumer goods imports, or to productive sectors whose financial viability is doubtful.

By end-June 1983, net domestic assets of the banking system (SL Rs 34,738 million) were 17.7 percent larger than in June 1982. While credit to the public sector had expanded by less than 1 percent over the 12-month period, credit to the private sector had increased by 30 percent.

5. Balance of payments

The authorities do not expect the short-run impact of the disturbances on Sri Lanka's external position to be large, as changes in various individual items of the balance of payments will be broadly

offsetting (Table 2). Within the export sector, the productive capacity of industries producing textiles and coconut oil has been damaged whereas most other export sectors were only slightly affected. The unfavorable effects on the textile sector should be mitigated by the existing considerable excess capacity in the industry, which can be put to use by redistributing among firms some of Sri Lanka's export quotas to Western markets, particularly the United States. As of August, a temporary ban has been imposed on coconut oil exports in order to avoid shortages in the domestic market but recent increases in world market prices for other coconut products should in part offset the effects of this on export earnings. Imports in 1983 are expected to be marginally less than previously forecast. Implementation of a number of public sector investment projects and private investment activity have slowed; on the other hand, some new imports will be necessary to replace destroyed property and to replenish depleted stocks of inputs and raw materials. The authorities expect that the net effect of the disturbances on services and private transfers will be small as the adverse impact on tourism receipts would be partly offset by lower interest payments resulting from lower capital inflows in 1983. As a result, the current account deficit should be marginally lower than envisaged earlier (Table 2). Receipts of official transfers are estimated to be larger because of the receipts of emergency grants.

The reduction in imports of investment goods is matched by a smaller inflow of capital. In addition, the uncertainties created by the events are likely to have a negative impact on inflows of private capital in 1983. However, the evidence so far--such as recent movements in international reserves--indicates that this may be limited. 1/ Consequently, the deficit on the overall balance of payments is not estimated to be much different from that previously forecast.

The staff feels that some of the estimates made by the authorities, particularly those on tourism and private transfers may be somewhat optimistic. On the other hand, the staff believes that the impact of the slow-down of investment activity on the demand for imports will be larger than envisaged by the authorities but that the overall deficit for 1983 will be broadly as estimated.

1/ At end-June 1983, gross official reserves (i.e., Central Bank plus foreign assets of the Government) amounted to SDR 266 million and net international reserves were negative (-SDR 80 million). The respective levels for May 1983 were SDR 276 million and minus SDR 52 million. Based on preliminary data for the Central Bank, gross international reserves of the Central Bank declined from SDR 264 million in May 1983 to SDR 259 million at end-August 1983, but the net foreign liabilities of the Central Bank fell during the same period from SDR 28 million to SDR 11 million. The improvement in the net position was of the order of SDR 12 million in August.

Table 2. Sri Lanka: Balance of Payments, 1982-83

(In millions of SDRs)

	1982	1983	
		Program forecast	Revised forecast
Exports, f.o.b.	934	971	960
Imports, c.i.f.	<u>-1,826</u>	<u>-1,763</u>	<u>-1,730</u>
Trade balance	-892	-792	-770
Services, net	-16	-41	-40
Private transfers, net	<u>240</u>	<u>263</u>	<u>260</u>
Current account balance	-668	-570	-550
Official transfers, net	147	150	154
Nonmonetary capital			
Private sector and public corporations, net	240	137	125
Central Government, net	<u>231</u>	<u>270</u>	<u>252</u>
Total capital account	471	407	377
Errors and omissions	<u>26</u>	<u>--</u>	<u>--</u>
Overall balance	-24	-13	-19

⁵ Sources: Data provided by the Sri Lanka authorities, and staff estimates.

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The changes in the external value of rupee have continued in line with the agreed formula. By end-August, the value of the rupee was SL Rs 24.37 per U.S. dollar, a level slightly more depreciated than the result of the formula.

6. Commitments under the stand-by program

The authorities have indicated that they are firmly committed to the thrust of policies announced under the negotiated program for 1983 and 1984. The present liberal exchange and trade system, strict financial discipline and the more flexible pricing and exchange rate policies will be continued. While it is difficult to assess the medium-term impact of the recent disturbances, and while some of the assumptions and immediate targets for the 1984 program are likely to be different from those specified in EBS/83/166, the authorities believe that for now the best course of action is to observe the policy commitments and performance criteria set under the negotiated program; in terms of credit policy, the observance of the ceilings would be consistent with the estimated balance of payments outcome for 1983 as well as the revised price and GDP projections. The studies in the four structural policy areas included as part of the commitments under the negotiated program are proceeding, although with some delays.