EBS/83/166
Supplement 3

CONFIDENTIAL

September 15, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Sri Lanka - Stand-By Arrangement

Attached for the records of the Executive Directors is the text of the stand-by arrangement for Sri Lanka agreed at Executive Board Meeting 83/139, September 14, 1983.

Att: (1)

Sri Lanka: Stand-By Arrangement

Attached hereto is a letter dated August 8, 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 September 14, 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
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> (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 8, 1983
Colombo, Sri Lanka

Sri Lanka - Letter of Intent

Dear Mr. de Larosière,

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 Larosière
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.