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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/139

10:00 a.m., September 14, 1983

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Alfidja	M. K. Diallo, Temporary
J. de Groote	
B. de Maulde	
A. Donoso	
R. D. Erb	
M. Finaish	
T. Hirao	T. Yamashita
J. E. Ismael	
R. K. Joyce	D. I. S. Shaw, Temporary
A. Kafka	
G. Laske	G. Grosche
G. Lovato	C. P. Caranicas
R. N. Malhotra	A. S. Jayawardena
Y. A. Nimatallah	J. E. Suraisry
J. J. Polak	T. de Vries
A. R. G. Prowse	K. G. Morrell
F. Sangare	O. Kabbaj
M. A. Senior	J. L. Feito
	A. Lindø
	C. Taylor
Zhang Z.	Wang E.

L. Van Houtven, Secretary
J. A. Kay, Assistant

Also Present

African Department: O. B. Makalou, Deputy Director; J. L. Bornemann, F. d'A. Collings, P. J. Duran, C. Enweze, C. E. Hunter, J. W. Kratz, R. L. Sharer, D. E. Syvrud, P. C. Ugolini, A. C. Woodward. Asian Department: P. R. Narvekar, Deputy Director; P. Chabrier, J.-P. C. Golle, S. W. Kane, P. R. Narvekar, R. H. Nord, D. A. Scott, G. Szapary, Wang X. European Department: L. A. Whittome, Counsellor and Director; E. O. C. Brehmer. Exchange and Trade Relations Department: C. D. Finch, Director; W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; M. Guitian, S. Kanesa-Thasan, J. M. T. Paljarvi. External Relations Department: A. M. Abushadi, H. O. Hartmann. IMF Institute: V. Chitty, J. M. T. B. Jayasundara, Participants. Legal Department: G. P. Nicoletopoulos, Director; G. F. Rea, Deputy General Counsel; J. M. Ogoola, A. O. Liuksila, S. A. Silard. Research Department: R. R. Rhomberg, Deputy Director; L. Alexander, H. H. Zee. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; A. P. Bhagwat. Treasurer's Department: D. Williams, Deputy Treasurer; D. Gupta, J. R. Karlik, G. Wittich. Western Hemisphere Department: S. T. Beza, Associate Director. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: A. A. Agah, J. R. N. Almeida, C. J. Batliwalla, S. E. Conrado, J. Delgadillo, S. El-Khouri, S. M. Hassan, L. Ionescu, H.-S. Lee, Y. Okubo, P. D. Péroz. Personal Assistants to Executive Directors: E. M. Ainley, H. Alaoui-Abdallaoui, J. Bulloch, M. B. Chatah, R. J. J. Costa, M. Eran, G. Ercel, I. Fridriksson, G. Gomel, V. Govindarajan, D. Hammann, N. U. Haque, C. M. Hull, J. M. Jones, A. K. Juusela, H. Kobayashi, M. J. Kooymans, P. Leeahtam, W. Moerke, G. W. K. Pickering, E. Portas, J. Reddy, Shao Z., M. Toro, Wang C. Y., J. C. Williams.

1. FUND LIQUIDITY - STATEMENT BY MANAGING DIRECTOR

The Managing Director made the following statement:

I would like to inform the Executive Board of my understanding of the outcome of the meeting of the central bank governors of the Group of Ten at the monthly meeting of the BIS on Monday, September 12, 1983. In telephone conversations over the last two days with Mr. Poehl, President of the Bundesbank and currently Chairman of the G-10 Central Bank Governors' Committee in the BIS, and Mr. Leutwiler, President of the BIS, I was informed that the Governors came to the widespread and even unanimous view not to go ahead with the project for a further loan agreement, at least for the time being. I do not believe it would be fruitful to go into details at this time.

The outcome of the recent meeting in Basle raises some questions regarding the financial viability of the present policy on enlarged access and what options we should consider regarding the working of that policy. As Executive Directors are aware, the Fund has been concluding new stand-by and extended arrangements under the policy on enlarged access to resources involving the commitment to provide borrowed resources without, since March of this year, having available lines of credit to back up those commitments. The so-called commitment gap is now SDR 3.5 billion, as you know; the staff has estimated that it will rise to SDR 6 billion by the end of this year or early 1984, on indications of likely use of the Fund's resources under the policy on enlarged access.

You will remember that I stressed in my statement of September 7, 1983 (Buff 83/234), which I had conveyed to Governors of the Group of Ten--and it might be useful if it were in the hands of Ministers for the forthcoming meetings in Washington--that this commitment gap needed to be closed urgently and that failure to do so would weaken the Fund's liquidity position and its image in a very uncertain and difficult international financial environment. I also stated at that time that if matters regarding new credit to the Fund proved to be more difficult, or take longer than expected, I would appraise the Board of all the options available, including a cutting back of any new commitments. Given the result of the meeting on Monday, I believe it is now necessary to consider some of those options.

First, we could, theoretically, continue our present policy and enter into new stand-by and extended arrangements without the assurance of financing becoming available in the next few months. The commitment gap would continue to rise, and disbursements under the new, as well as outstanding, arrangements would be made from present undisbursed proceeds of existing loan agreements. As of the beginning of September, the undisbursed proceeds of existing loans amounted to SDR 6.2 billion, of which SDR 0.7 billion is under the supplementary financing facility and the remainder under the enlarged access policy lines of credit. As the staff has indicated in the most recent review of the Fund's liquidity position (EBS/83/170, 8/12/83), balances under the existing lines of credit are expected to be fully disbursed by June 1984, i.e., by June 1984 we would not have any cash resources available under existing lines of credit, taking account of the phasing of outstanding arrangements and new arrangements expected to be entered into in the next few months. In short, on this count we will have exhausted all existing lines of credit by around mid-1984.

If such a course of action were envisaged, the Fund's uncovered commitments to supply borrowed funds would have to be met in the last resort from the Fund's ordinary resources. I would say that this is so by definition if we cannot arrange alternative lines of credit to meet disbursements under arrangements. The squeeze on our usable ordinary resources is, however, as I mentioned earlier this month, becoming progressively tighter. The Fund's holdings of uncommitted usable currencies and SDRs amounted to SDR 10 billion at the beginning of September and are projected to fall to about SDR 6.7 billion by the end of 1983 or early 1984, if we continue our present policy. This amount would barely exceed the projected commitment gap of SDR 6 billion as of the end of 1983 or early 1984, and would leave virtually no margin of uncommitted resources to finance other drawings on the Fund, including those under special facilities, first credit tranches, and the reserve tranche. The Fund would be compelled, under such a course of action, to cease all operations at the beginning of 1984. This is obviously impossible.

If the Fund's liquidity position was looked at on a true cash or disbursement basis, the following would result: the total of usable currencies and SDRs (adjusted for working balances) plus available lines of credit at the beginning of September was SDR 21 billion, and the total is projected to fall to SDR 14.1 billion by December and to approximately SDR 7.5 billion by June 1984, the date by which time it is expected that the existing lines of credit, as I said, would be exhausted. In contrast, the Fund's commitment to disburse resources under existing and new arrangements, while being spread over a period of time reflecting the length of the arrangements, are projected to amount to SDR 13.4 billion as of the end of 1983 and to SDR 10 billion by June 1984. In addition, provision will need to be made to accommodate drawings under the special facilities and in the reserve tranche; reserve positions in the Fund, including loan claims, are expected to total approximately SDR 45 billion by June 1984. Starting in the spring of 1984, when the total of undrawn commitments will equal or begin to exceed the Fund's total usable assets, it will become over time practically impossible for the Fund to meet both the disbursements under undrawn commitments and to engage in other operations and transactions with members on the scale that might be required in the period ahead, i.e., the Fund could be put in a position where it would be unable to honor past commitments. Effectively depleting the Fund's liquid resources while continuing our present enlarged access policy would thus lead us into an impossible position.

I do not believe that a rapidly deteriorating liquidity position is tenable for an institution such as the Fund. Consequently, we must now consider, inter alia, whether we can prudently let the commitment gap rise over the next few months in the absence of reasonably firm indications on the means of financing it.

In this regard, one solution could be for the Fund to cease entering into any new arrangements involving the enlarged access policy--i.e., to effectively suspend the policy on enlarged access so that the Fund would not, for the time being, enter into further commitments involving borrowed resources under the policy on enlarged access. We could also consider various alternative modalities to ration access to the Fund's resources, including ordinary resources, on an availability basis with perhaps subsequent augmentation when resources become available. I have asked the staff to examine urgently various alternative approaches that could effect a slowing down of the drain on the Fund's resources.

It would be possible to consider immediately, as of today, a change in the Fund's policy on the use of its resources, but it might be considered too sudden and precipitous an action to effect a change in policy now, and I shall not recommend it. However, I believe the Executive Board must examine, in the period immediately after the Annual Meetings, probably October 3, 1983, a course of action that would effect some slowdown in the use of the Fund's resources, or at least to introduce some contingency provision making the use of resources conditional on the availability of financing to this institution.

I do not believe that in present circumstances it would be appropriate for the staff to continue or engage in discussions with members requesting the use of Fund resources that would involve further commitment by the Fund of borrowed resources under the policy on enlarged access, and I plan to give appropriate instruction to staff missions on this matter. This would mean that the Fund should not enter into new arrangements that would involve the commitment of borrowed resources under the policy on enlarged access beyond those requests that are for consideration by the Executive Board prior to the review that I indicated should take place immediately after the Annual Meetings.

The Executive Directors took note of the Managing Director's statement.

2. LIBERIA - STAND-BY ARRANGEMENT

The Executive Directors considered a request from Liberia for a stand-by arrangement for a period of one year in an amount equivalent to SDR 55 million (EBS/83/175, 8/17/83).

The staff representative from the African Department informed Executive Directors that data received by the staff for end-August 1983 indicated that total credit, credit to the Government, and external payments arrears had all been in line with the performance criteria for November 1983 under the program.

Mr. Sangare made the following statement:

Introduction

This is the third Board discussion on Liberia in just under one year. Directors will recall that last September the Board considered economic developments in Liberia in connection with a request for a stand-by arrangement, which was followed in February by a discussion of the 1982 Article IV consultation report and the review of the stand-by arrangement. The economic problems of Liberia therefore are not new to Directors; however, they have intensified. Under the circumstances, the immediate concern of my Liberian authorities remains the need to correct imbalances in the economy, and they are committed to consolidating the progress made in this regard as a result of the stabilization efforts that began three years ago.

It is proper to note that assistance from the Fund in the form of three consecutive stand-by arrangements has proven to be invaluable in helping the authorities cope with the unprecedented difficulties that they are experiencing. They have therefore asked me to record their gratitude for the understanding shown by the Fund over the years. My authorities are looking forward to continuing cooperation with the Fund to find solutions to their economic difficulties.

Issue of structural adjustment

On previous occasions, I have drawn the Board's attention to the fact that my Liberian authorities are constrained to a large extent by structural problems that not only hamper economic growth but also adversely affect the financial position of the Government. Various reports have highlighted this situation by pointing out the economy's dependence on a few export commodities--iron ore, rubber, and timber--and, therefore, its vulnerability to external developments. As evidence of this, the prolonged recession in the international economy has resulted in a cumulative decline in real GDP of more than 8 percent over the past three years. My authorities' concern about the need to restructure the economy is therefore a justifiable one, particularly as their commitment to sound, though difficult, adjustment policies is being frustrated by developments in the external economy.

In the circumstances, economic management in Liberia requires not only the implementation of policies which influence financial aggregates, important as these may be, but also those that aim at changing the structural character of the economy and reducing its vulnerability to external developments. The authorities therefore continue to be aware of the fact that there can be no substitute for careful planning aimed at diversifying the productive base of the economy within the context of a long-term development strategy, and that this must be supported by measures channeling resources into productive investment. Unfortunately, continuing pressure on the Government's budget is making the latter more and more difficult to achieve. Against this background, the importance of increased external assistance to Liberia on concessionary terms cannot be overemphasized. The authorities therefore welcome the efforts being made by certain multilateral agencies and major donor countries in helping to arrange a conference in Geneva in October to assess Liberia's development program with a view to augmenting their financial support.

Implementation of the 1982/83 program

The program was an attempt to build upon the achievements of the Government's stabilization efforts that began in mid-1980. There were four principal objectives: improving further the financial position of the public sector, increasing the share of public expenditure allocated to productive investment, strengthening the country's capacity to mobilize domestic financial resources, and improving the external reserve position of the National Bank.

As in the past, most of the measures agreed with the Fund in support of these objectives were implemented. These included cuts of up to 25 percent in salaries of public sector employees, a reduction in the local development budget by $9.2 million, and a cut in other recurrent expenditure by $7.5 million. In addition, steps were taken to collect personal income tax withheld by public corporations but not remitted to the Government and overdue stumpage fees from private corporations.

Despite all these measures, the improvement in the budget which had been envisaged did not materialize, as the deficit is now expected to exceed the program target by $14 million. The reason is that while total expenditure remained below the programmed level, total revenue fell short of the target by $26.6 million, or 9 percent, resulting in the main from the decline in economic activity in 1982/83, which led to customs duties and excise taxes being significantly below the amount incorporated in the budget. Nontax revenue was also below the projected level.

To explain the Government's fiscal problem better, perhaps, I should recall that when the program for 1982/83 was being prepared, it was hoped that the economy would begin to recover after two years of negative growth, and that real GDP would register an increase of 2 percent. This hope was pinned on the projected outlook in the world market for Liberia's major export commodities, iron ore and rubber, which at the time looked promising. Unfortunately, the demand for and prices of these commodities remained depressed, and, instead of growing by 2 percent, real GDP declined by about 4 percent, with the attendant consequences for employment and government revenue.

The second problem that affected the program was the difficulty that the Government experienced in reaching agreement on the elimination of arrears with the group of 24 banks that had been financing the country's oil imports, making Liberia ineligible to receive the final two installments under the stand-by arrangement. It will be recalled that the Fund decided on February 25, 1983, at the time of the review of the stand-by arrangement, that purchases under the arrangement would be prohibited during any period after May 14, 1983 when Liberia had outstanding external arrears.

I should stress that this was a very disturbing experience for my authorities because, despite all attempts to reach an amicable settlement with the parties concerned, and despite the willingness of the lead bank in the facility to go along with the Government's proposal, some of the banks in the consortium refused to negotiate in good faith, which meant that the matter was beyond their control. It was difficult, therefore, for the authorities to see how the decision of the Fund could have helped the situation. If anything, the Fund's decision had hurt their efforts, because, by not being able to complete purchases under the stand-by arrangement, they were unable to achieve the objective of strengthening the external position of the National Bank of Liberia. Without belaboring the issue, I should say that the difficult position of my authorities proves that the concern that I expressed in the Board at the time about the Fund's decision was well founded.

The 1983/84 program

The budget remains the critical area of adjustment in the current program, which is aimed at moving the economy toward a sustainable balance of payments position. Many of the issues emphasized by Directors during the discussion last February have been given due attention in the program, including, in particular, the question of domestic and external arrears, which the authorities feel should be addressed as an integral part of the Government's campaign to restore confidence in the financial management of the country. In this connection, the authorities are committed to the complete elimination of external arrears by May 31, 1984, while domestic arrears are to be held at the level recorded at the end of June 1983.

Apart from the pursuit of prudent fiscal policies, the realization of the program's objectives depends upon the fundamental assumption that the recent strengthening of Liberia's main export markets will continue during the course of 1983/84. On this basis, export earnings are projected to increase by 12 percent during the program period, and a modest growth in real GDP is expected.

Fiscal restraint in 1983/84 will entail additional cuts in personnel costs, totaling $14 million and a continuation of the freeze on salary and employment. Efforts are also being made to eliminate vacant posts within the various departments and to make some positions redundant. Economies will also be effected in other areas aimed at reducing recurrent expenditure on a check-issue basis by a further $9 million. Recent measures announced in line with these objectives include selling government vehicles to their users, reducing travel expenditure, and making across-the-board cuts in expenditure for services, materials and supplies, and subsidies. Domestic financing of the development budget will be held slightly below the level budgeted in 1982/83, with priority given to projects nearing completion, those with a high rate of return, and those with maximum foreign financing. Nonbudgetary expenditure will be authorized only by the Economic and Financial Management Committee, whose authority has been strengthened, and, to the extent that cuts are made elsewhere, the revenue target is being achieved.

New revenue measures already taken are expected to yield $16.9 million, principally the increase in the excise tax on gasoline from 32 cents to 92 cents per gallon and the increase in the consular fee on transshipment goods from 2.5 percent to 7.5 percent. These actions are being buttressed by the rigid collection of taxes now under way.

The budget deficit as a percentage of GDP is expected to drop by some 5 percentage points, from 8.7 percent in 1982/83 to 3.6 percent in 1983/84. As a result of the improved budgetary situation, domestic bank financing is projected to fall to the equivalent of 2.6 percent of GDP in 1983/84 from 6.8 percent a year earlier.

Efforts to improve the efficiency of public corporations are continuing, and transfers to them from the current budget are being contained. Credit to public corporations also has been limited. Meanwhile, the Government is working with the World Bank to identify those corporations that should be sold to the private sector or operated as joint ventures and to establish an agency to monitor the performance of all public corporations. The authorities also intend to review the reserve requirement for savings deposits to determine appropriate actions that will enable commercial banks to pay higher rates of interest as a means of improving the mobilization of domestic financial resources.

Liberia's balance of payments will remain under pressure during the program period. As for the medium-term outlook, much will depend on the revival of economic activity in Western Europe and the United States, the principal markets for Liberia's exports. Prices for rubber and timber have increased slightly, but prices for iron ore have remained sluggish. With a projected increase in exports of 12 percent in 1983/84, the current account deficit is expected to decline to $50 million from $74 million in 1982/83.

The authorities hope to reach agreement on further debt rescheduling under the aegis of the Paris Club and on another London Club refinancing of principal repayments due on debt owed to private banks. The Government has already initiated contact with the parties concerned.

Conclusion

I will conclude by reaffirming my authorities' commitment to the program and assuring the Board of their intention to take any further measures that become necessary to achieve the objectives of the program. The authorities have agreed to hold immediate consultations with the Fund in the event that some of the key variables in the program appear to be going off target. This, I think, is but another manifestation that the authorities not only wish to see the program succeed but that they also have the will.

Mr. Erb stated that he was in broad agreement with the staff appraisal and that, while he would raise a question regarding one part of the proposed stand-by arrangement, he could support the proposed decision. Although there had been some limited progress in the Liberian economy during the past year, the situation had not been encouraging. In February 1983, when the Executive Board had previously discussed Liberia (EBM/83/39, 2/25/83), he expressed his growing concern with developments in Liberia's external arrears and, more broadly, with the role being played by the commercial banks in Liberia. It was regrettable, as the staff had said, that it had not been possible for the authorities and the banks in the oil facility financing group to reach an agreement that would effectively eliminate Liberia's arrears and lead to the maintenance of an appropriate level of commercial bank exposure. His authorities had stated that it was not desirable for commercial banks to seek unilaterally to reduce their exposure in Liberia, particularly when Liberia was receiving relatively large amounts of finance from the Fund and official donors. His authorities wished to have a further explanation from the staff as to why its particular approach to the problem had been taken. In the circumstances, the Fund staff should closely monitor developments in connection with the arrears and also be in a position to say whether expectations regarding net new commercial financing were being met during the program period.

His authorities, Mr. Erb went on, had two concerns regarding the proposed debt rescheduling in the Paris and London Clubs. The first was that the rescheduling agreements should be arranged in such a way as not to favor one class of creditors, for instance commercial banks, at the expense of others. The second was the poor quality of the debt data available in Liberia. He was glad to learn that a consultant had been designated under the Fund's Central Banking Department Technical Assistance Program, and that he was expected to arrive in Monrovia during September 1983.

Commenting on the fiscal policies for 1983/84, Mr. Erb remarked that the proposed reduction in the overall deficit from 8.7 percent of GDP to 3.6 percent was an ambitious undertaking. While the key elements needed to meet that target seemed to be in place, great vigilance and flexibility would be required if the target was to be achieved. The decisions to reduce personnel costs were particularly courageous and merited commendation. The authorities should hold the line on other expenditures in order to avoid the sacrifices on the wage front from being in vain. He was glad that the staff was to monitor expenditures monthly. The rationalization of the petroleum sector was long overdue. The initiative should help to improve the efficiency of the economy, and he would welcome any further information on how the process was going.

He was also glad to see that the authorities had taken steps to obtain larger financial flows and more technical assistance from international organizations, Mr. Erb asserted. He had noted the staff's belief that Liberia could achieve a sustainable balance of payments position over the medium term if the authorities continued to pursue the proposed policies, and if there were a moderate recovery in exports. He agreed with Mr. Sangare that the authorities should pursue policies aimed at changing the structural character of the economy, thus reducing its vulnerability to external developments. Such a structural effort would require not only long-term finance but also commercial investment flows. Fund financing would not be an appropriate substitute. In that connection, he wondered whether any further information was available regarding the status of the preparations for the conference of aid organizations, both multilateral and bilateral, that was planned for October 1983. The authorities ought to begin to develop a more comprehensive investment plan for implementation as the world economy picked up.

Mr. Shaw recalled that on two earlier occasions, when the affairs of Liberia had been discussed by Executive Directors, a number of them, including his chair, had been concerned about the small margin for error in the program approved in September 1982. By June 1983, it had become clear that the program had failed because the performance criteria for the net claims of banks on the public sector and on the Government had not been met. He agreed both with Mr. Sangare and with the staff that the fiscal targets had been largely met on the expenditure side, where there had been a severe adjustment. However, the major weakness in the program for 1982/83, as in the program for 1981/82, was on the revenue side. The same point had been made by Executive Directors on the earlier occasions. Although the authorities did deserve great credit for making significant adjustments on the expenditure side, revenues had remained stagnant or had even declined. The authorities' intention was to tackle the severe overall fiscal deficit for 1983/84 by further restrictions on the expenditure side. It was true that the staff had described a number of revenue measures that the authorities intended to take, but he wondered whether they would be effective. If they did not, the program might meet the same fate as the previous one.

He agreed with Mr. Erb, Mr. Shaw went on, with regard to the elimination of external arrears through a rescheduling of the $26 million due to the consortium of banks under the oil facility financing scheme. Like Mr. Erb, he would be interested to know whether there was any recent information on the negotiations.

Regarding the reform of public enterprises, the authorities had made some significant progress, Mr. Shaw considered, in particular by being committed to rationalize the petroleum sector, by closing the state-owned oil refinery, and by introducing private competition. The sale of other public corporations to the private sector should also help to introduce some competitiveness into the economy.

On the external side, the balance of payments position was dependent on the competitiveness of Liberia's exports, Mr. Shaw remarked, because the authorities had little room for action through the exchange rate. He noted that in 1983/84 exports were expected to return to a level only slightly above that of 1981/82. There seemed to have been a decline in output during 1982/83, and any improvement in the balance of payments in the coming year was therefore bound to come from import compression rather than from export growth. Such a situation might place restraints on the productive capacity of the economy and hamper attempts to diversify in the medium term. It would be useful if the staff could say whether it believed that there would be any adverse effects from the severe import compression, particularly, for instance, on the prospects for agricultural development. More generally, he would like to see a wider discussion of the possibilities of medium-term diversification in a future Article IV consultation.

In brief, Mr. Shaw concluded, he could support the stand-by arrangement although he had some worries regarding the fragility of the budget situation. In view of the restrictions imposed by the use of the U.S. dollar as Liberia's currency, it was essential for the authorities to continue their adjustment on the fiscal side and to put more emphasis on revenue improvement. The balance of payments outlook, which was closely linked to fiscal improvement, might recover as export markets improved. He also hoped that the balance of payments would recover with increased capital inflows when some accommodation was made with the commercial banks. Despite his remarks, he was encouraged by the program and by the commitment of the autorities to take severe action in a number of fields, including diversification of the economy.

Ms. Diallo remarked that the Liberian economy had been experiencing difficulties in recent years due to the slowdown in the economies of its main trading partners. The consequence had been a sharp deterioration in the terms of trade of Liberia, reflecting in particular a sharp decline in the export of its main tradable goods, iron ore, timber, and rubber. Reap GDP was estimated to have declined by 4 percent in 1982/83, while the value of exports had fallen by 11 percent. Although the Liberian authorities had implemented some adjustment measures with the support of the Fund, the results had been less than expected. The shortfalls in some aspects of the program had, however, not discouraged the authorities. Indeed, measures such as the reduction in wages and salaries by 16-25 percent in January 1983, and the reduction in government expenditures by 10 percent from the previous year, should help the authorities to carry their adjustment efforts to success.

Although the country had suffered a shortfall of 8 percent in its export revenues, Ms. Diallo went on, in 1982/83 it was expected that the current account deficit would represent only 6.5 percent of GDP, compared with 8.2 percent in the previous year. Despite the serious constraint represented by the lack of external reserves, the authorities had tried to keep their external payments under control until at least the last quarter of 1982/83. Unfortunately, because of unforeseen difficulties with the oil import credit facility, the authorities had had to approach the London Club for a settlement of their external debts to private undertakings.

Despite the authorities' commendable efforts to correct the serious economic deficiencies of recent years, the country's financial situation remained difficult, Ms. Diallo observed. The authorities therefore had adopted an economic program for the period 1983/84 that needed Fund support. The main objectives of the program were to bring about a reduction in the volume of domestic bank credit to the Government and to strengthen the external sector. The major difficulties facing the Liberian economy lay in the fiscal field, and the authorities had rightly put the emphasis on fiscal measures. Taken together, they were expected to raise an additional $16.9 million in FY 1983/84.

The authorities had taken courageous steps on the expenditure side, Ms. Diallo considered. They had frozen the salaries of public sector employees, cut down personnel costs, and sold government vehicles to their users, among other actions. The authorities' objective was to limit the overall budget deficit of $42.4 million in 1982/83. The steps they had taken would certainly also help to reduce substantially the amount of bank credit required by the Government. She hoped that the efforts of the authorities to reduce the current account deficit to $50 million in 1983/84 would also be successful. She welcomed the fact that, despite their many difficulties, the authorities were still committed to eliminating external arrears and to following a cautious external borrowing policy.

Mr. Finaish said that in general he shared the concerns of earlier speakers. The staff papers revealed a consistent deterioration in real economic activity and in the country's external finances. Real GDP had fallen by about 8 percent, implying a drop in per capita GDP of more than twice that amount; exports had fallen by more than 7 percent a year; the overall ratio of the balance of payments deficit to GDP had almost doubled in the same period, which had been marked by three consecutive stand-by arrangements with the Fund.

The staff proposals for 1983/84, Mr. Finaish noted, were similar to those in earlier programs. The focus was again on public sector financing and on the containment of government expenditures, in the hope that fiscal adjustment would produce a turnaround in the balance of payments position. There seemed to be some ambiguity on the part of the staff, since it had written on page 14 that "the proposed stand-by program aims at a sustainable balance of payments position by the end of the program," while on page 30 it had said that Liberia should be able to reach a sustainable balance of payments position over the medium term. It would be useful to have a staff comment on the point. In any event, the projections for the balance of payments in Table 7 of EBS/83/175 seemed rather optimistic. For instance, imports were projected to increase by only 6 percent during 1983/84 in nominal terms. In view of the turnaround in economic activity expected by the staff and the temporariness of the drop in imports in 1982/83, explained as being due in the main to difficulties of unloading in Monrovia and the decline in imports of oil, the rise in imports during 1983/84 might well be larger than the staff had estimated. On the export side, the program provided for a 12 percent increase during the coming year. While an imporvement of the world economic environment should be expected to help the export sector, he wondered whether Liberian exports were not also affected by the continuing appreciation of the U.S. dollar. Table 7 of EBS/83/175 showed that the improvement in the overall balance of payments for 1983/84 was contingent on a substantial change in the capital account, and the basis for the expected increase in capital inflows seemed to be tentative at best.

More generally, Mr. Finaish went on, he still wondered whether the present approach was the one most likely to solve Liberia's financial difficulties. In view of Liberia's exchange system, the staff was forced to focus on fiscal adjustments, hoping that they would be sufficient to offset the external imbalances. It would be useful to hear the staff comment on the point. Finally, in light of the experience with the three previous programs, he doubted whether a fourth stand-by arrangement in the form outlined by the staff would be a useful way of overcoming the imbalances in the Liberian economy.

The staff representative from the African Department, replying to questions, explained, first, the role of the commercial banks in Liberia, with particular regard to the oil financing facility. Executive Directors would remember that in 1982/83 the Government of Liberia had been financing its oil imports through a 24-bank consortium; the Government had tried to renew the facility, which would have provided $9 million to $10 million in credit to finance Liberia's oil imports. The attempt had failed because 2 out of the 24 banks had refused to participate. Talks with the consortium had finally broken down on June 30, 1983, and on July 1 the Government of Liberia had requested a rescheduling of payments due under the oil facility agreement, through the London Club. The lead bank in the facility had agreed that such an approach would be reasonable, and it was in communication with the banks on the Steering Committee of the London Club to reschedule the debt on the same terms and conditions as other debts were rescheduled in that forum. The staff had not made the rescheduling a precondition for the 1983/84 program because it did not wish Liberia to be held hostage again by a small number of banks in the facility. In any event, all those concerned had agreed that the debt should be rescheduled.

A number of Directors had commented on the rationalization of the petroleum sector, the staff representative noted. The staff considered the petroleum sector to be one of the most uneconomic sectors in the Liberian economy, and the existence of the oil financing facility was of course part of the problem. In July 1983, the Head of State had announced that the oil refinery, which had been producing refined products at a direct refining cost of about $4.50 per barrel, compared with the average refinery's cost of $1.50 per barrel, would be closed. He had gone on to decree that the importation and distribution of petroleum products were open to the private sector. Two major oil companies were studying arrangements to import oil and distribute it throughout the country. Not only would the oil companies provide a more consistent flow of oil to the country, but, having their own financing arrangements, they were also likely to provide additional funds for Liberia.

As to whether the present policy followed by the staff was the most appropriate for Liberia, the staff representative recalled that after the change of government in April 1980, public sector salaries had been doubled. Public sector expenditures had become very high, and attempts had been made ever since to reduce the deficit. Nevertheless, attempts should be made to separate the artificial increase in GDP that had come about from the public sector spending and the increase in GDP from the real economy. Liberia's economy had been primarily dependent on exports of iron ore, rubber, timber, coffee, and cocoa, and the diversification into other agricultural products was bound to take a long time. For the most part, the external deficit was due to a decline in the export of major commodities, for reasons beyond the control of the authorities. It was true that the link between the Liberian dollar and the U.S. dollar resulted in an appreciation in both nominal and real trade-weighted terms. On the other hand, the consumer price index--the only index available in most developing countries for use as a deflator--did not reflect the cost-cutting measures that had been taken. In the iron ore industry, one third of the labor force had been dismissed, while in the rubber industry there had been a complete overhaul of operations to make the industry more competitive. Public sector salaries had been cut by between 16 percent and 66 percent, setting a standard for nongovernment activities. Liberia's export industries had in fact become cost competitive despite the appreciation of the U.S. dollar. The staff therefore believed that, with the pickup in the world economy, Liberia would be in a good position to achieve a sustainable external balance.

Regarding the import compression, the staff representative remarked that much of it had been due to the reduction in imports of petroleum in 1982/83. For the coming year, the staff had projected a significant increase in exports and a modest increase in imports. In the medium term, diversification was essential. The staff had been working with the World Bank, which was considering a structural adjustment loan for Liberia in 1984/85. Such a loan would be helpful from the standpoint not only of diversification but also of providing resources that would substitute for Fund financing in the year following the stand-by program.

While the staff felt that it was essential for the Liberian authorities to bring the budget under control, the staff representative from the African Department concluded by observing that, despite the decline in income in Liberia, income tax collections had exceeded the targets in 1982/83. For 1983/84, the tax on gasoline, to be collected at the port of entry, was to rise from 32 cents to 92 cents per gallon; the increase should have a major effect on the Government's revenues. The key problem was really the containment of public sector expenditures, and the staff had been encouraging the authorities to strengthen their means of monitoring expenditure control.

Mr. Erb inquired whether the staff could say at what point Liberia was likely to achieve a sustainable balance of payments position.

The staff representative from the African Department commented that the commercial banks had been reducing their exposure in Liberia at the time that the Fund had been making resources available. The Liberian authorities had accomplished a great deal in terms of containing the public sector deficit, and even the external deficit, so that the outlook for private bank financing was encouraging. Two major banks had indicated that they were increasing their exposure in Liberia. While investment decisions were still to be made, during the past year the iron ore industry had increased its productivity substantially and during the current year had been exporting at a sufficient rate to reduce its inventories fairly quickly, thus contributing to the balance of payments. The decision by the World Bank regarding a structural adjustment loan would also have a substantial influence on the balance of payments position. Unless the World Bank decided to grant that loan, it would be taking money out of Liberia within the next year or two; hence, Liberia was dependent on the investment decisions of the World Bank as well as of other undertakings. Nevertheless, taking all the financing sources together, including the U.S. Government, if the authorities pursued the program diligently, Liberia should be in a position to survive without further net use of Fund resources after the end of the program year now commencing.

The Chairman, referring to Table 7 on page 13 of EBS/83/175, remarked that for 1982/83 the use of Fund resources had amounted to $62 million, while the current account deficit had stood at $74 million. At the same time, there had been a $29 million withdrawal of capital from the commercial banks. In other words, the Fund seemed to have been financing virtually the whole of the balance of payments deficit of Liberia, while the authorities had been making substantial repayments to the commercial banks.

The staff representative from the African Department recalled that he had made the same point in 1982, when he had said that the banks concerned with the oil financing facility had already withdrawn $11 million to $12 million. Since then, the staff had been trying to persuade the Liberian authorities to take action to prevent the recurrence of such withdrawals by the commercial banks. The time had come when the staff would have to reconsider how to advise the Government in its handling of the commercial banks in order to ensure that they maintained their exposure. During the past year, the London Club had rescheduled the debts of Liberia. There were indications that the commercial banks resident in Liberia had reduced their exposure to the point where no further reduction was feasible. Two of the major banks had already increased their exposure by significant amounts during the current year.

The Chairman remarked that he would wish to see proposals for ensuring that the commercial banks in Liberia did not continue to reduce their exposure, and that the banks understood that the Fund's support for the Liberian authorities would depend upon the commercial banks maintaining their balances in the country, before the review under the stand-by arrangement in December 1983.

The staff representative from the Exchange and Trade Relations Department noted that the 1982/83 program had been constructed on the assumption that a large proportion of purchases from the Fund would be used to build up assets. Instead, there had been a flight of capital through the banking system. Clearly, the situation had been of great concern to the staff in preparing for fiscal 1983/84. Indeed, the staff had assumed that there would be an inflow of $10 million from the banking system, and he understood that such an inflow was already taking place. External liabilities of the commercial banks in Liberia were already so low that any further reduction seemed unlikely. As to the terms of rescheduling by the commercial banks, the terms of the London Club seemed rather similar to those of the Paris Club. They were relatively favorable to the Liberian authorities in the sense that they provided for rescheduling 95 percent of the principal by converting it into a six-year loan with a three-year grace period. If the oil financing facility were refinanced on those terms, it would be to the advantage of the Liberian authorities.

Mr. Sangare stated that his authorities felt that the Fund had been helpful during the difficult period that they had been facing. As to policy actions by his authorities, on the fiscal side they would concentrate on the public sector, and particularly on containing public sector expenditure. In practical terms, they were determined to limit the overall deficit to 3.6 percent of GDP and to hold their recourse to domestic bank financing to not more than 2 percent of GDP. The main effort would however be to tighten expenditure control and to strengthen financial discipline. The authorities had already initiated several measures that demonstrated their determination, including appointing a consultant team that had started to make physical accounts of public sector personnel. They had also appointed tax experts from donor countries.

On the external side, Mr. Sangare continued, the problem of arrears continued to be of major concern to his authorities. They fully understood the importance of eliminating arrears and had accordingly agreed on a rescheduling with the London Club. However, the main reason for the failure to settle the question of arrears had been the collapse of the agreement with the banks involved in the oil financing facility. His authorities had done all in their power to implement the measures on which they had agreed with the Fund, and they would continue to act in the same way. The staff's projections seemed quite reasonable to his authorities, especially as before 1979 the capital inflow into Liberia was much greater than the figures shown by the staff for the coming year. If all the measures were implemented correctly and discipline was maintained, the staff's projections seemed likely to be met.

His authorities felt that all the policy measures recommended by the staff had been introduced, Mr. Sangare explained. If they had failed in certain respects, it was because of factors beyond their control. What the authorities now needed was cooperation not only with the Fund but also with other donors, if the Liberian economy was to resume an upward path. As to exports, the problem was more one of lack of demand overseas than of the competitiveness of Liberian exporting industries. If the market were to improve, Liberian exports would rise accordingly. His authorities had demonstrated during the first three programs their desire to continue cooperation with the Fund and their intention to implement the measures that were within their control.

The Executive Board then took the following decision:

1. The Government of Liberia has requested a stand-by arrangement for a period of one year from September 14, 1983 for an amount equivalent to SDR 55 million.

2. The Fund approves the stand-by arrangement attached to EBS/83/175, Supplement 1 (9/15/83).

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

4. In accordance with the request of the Government of Liberia, the stand-by arrangement approved by the Fund for Liberia on September 29, 1982 is canceled as of September 13, 1983.

Decision No. 7521-(83/139), adopted
September 14, 1983

3. SRI LANKA - 1983 ARTICLE IV CONSULTATION, AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1983 Article IV consultation with Sri Lanka together with a decision concluding the 1983 Article XIV consultation with Sri Lanka and a request for a stand-by arrangement through July 31, 1984 equivalent to SDR 100 million (EBS/83/166, 8/9/83; Sup. 1, 9/7/83; Cor. 1, 8/16/83; and Cor. 2, 8/17/83). They also had before them a report on recent economic developments in Sri Lanka (SM/83/186, 8/17/83).

Mr. Jayawardena made the following statement:

1. Background

The adjustment effort in Sri Lanka since 1977 has to be analyzed against the background of postwar independence when, for nearly three decades, the economy was brought under increasing regulation and control, with a high welfare orientation, in the face of deteriorating terms of trade. This resulted in slow growth and growing unemployment. These policies have been reversed since 1977, when a free and open economy has been nurtured. Given the small size of the island economy, and its high vulnerability to vagaries of monsoonal weather, the authorities are conscious of the limitations of past endeavors at promoting self-reliant and inward-looking development. The results of the change have been most encouraging. The economy has bounced back to grow at more than twice the past growth. Unemployment has been halved. The elimination of cost-price distortions has restored incentives and business confidence.

Indeed, it is remarkable that these changes took place at a time when the world was battling its worst recession in many years, partly as a result of which Sri Lanka was faced with an unprecendented deterioration in terms of trade. It would appear that these adverse external developments retarded the pace of adjustment, particularly in 1980 and 1982; and I would welcome the current understandings reached with the Fund as a first decisive step in getting back on a path of adjustment. Naturally, the correction of a long-standing imbalance requires time. In a democracy, where governments have been often changed by open ballot, it also requires care. That the voters endorsed the recent thrust of government policies at elections held in late 1982 is an example of an enlightened electorate's placing the need of longer-term stability and growth above ephemeral benefits.

2. Economic strategy

The staff has focused on the fact that, although real growth has averaged 6 percent a year since liberalization, a major part of this growth has arisen from construction, trade, transport, banking, and services, with a critical contribution from paddy and other foodcrop sectors, whereas the traditional "commanding heights" of the economy--the tree crop sector--have lagged behind, and manufacturing output growth has been largely concentrated in low value-added garments and textiles. These developments have to be understood against the background of the long-neglected economy, where basic infrastructure had to be brought up as a matter of high priority, if the newly emerging private sector initiative was to be fostered. For instance, demand for power rose sharply after liberalization, and new capacities had to be created urgently to prevent an abortion of new initiatives. When interpreting the rate of manufacturing growth, we have to be mindful of the slowdown in tree crop processing and the closure of many formerly overprotected industries, which were unable to face import competition. The growth of garment and textile industries was a natural development of foreign and private sector initiatives, which took advantage of the high productivity of local labor (although further expansion is now constrained by quotas), as well as a government decision to transfer management of several large textile mills to the private sector. Moreover, inadequate infrastructure had to be rehabilitated and expanded to create necessary conditions for private sector growth. It is my authorities' view, therefore, that the pattern of growth that emerged, responding to critical bottlenecks, would not have been appreciably different under a different mix of policies.

The problems of the tree crop sector and their impact on export performance are well known, and have been frequently discussed at previous Board meetings. It is not that Sri Lanka, which has more than a century of experience in growing tea, rubber, and coconuts, lacks technology or management expertise in these fields, but the relative stagnation of this sector is a result of long neglect under adverse world price developments, and, since the land reforms of 1972/75, of well-known problems associated with public sector management. As the staff has pointed out, comprehensive estate-by-estate development plans have now been prepared to be implemented under a system of strong incentives to managers and workers. Hence, the current approach of my authorities should herald a revival of this sector, in due course.

3. Prices and employment

The staff has noted the significant gains in restructuring relative prices by curtailment of subsidies and extensive administrative and price controls during 1977-81. After a short relapse in 1982, my authorities have increased the momentum of price adjustments in 1983, which are documented in the staff papers. Inflation declined from over 20 percent at the end of 1980 to about 2 percent at the end of 1982, largely on account of a deceleration in world inflation, plentiful food supplies, and deferment of some changes in administered prices. But prices have picked up slowly in 1983, following exchange rate changes, administered price adjustments, and the new tax measures; inflation is expected to level at about 10-11 percent by the end of 1983, of which more than half will be accounted for by administered price changes, thus reflecting an underlying inflation rate of about 5 percent. My authorities expect to contain price increases further to about 8 percent in 1984.

Employment has continued to expand, and current unemployment stands at 14 percent, a big decline from 24 percent in 1977. This situation has been helped also by migration of workers abroad, whose remittances now account for nearly a third of the country's export earnings. Training people in new skills to replace those of emigrating Sri Lankans has proceeded smoothly, and there have been no serious bottlenecks in the labor market.

4. Public finance

The major element in public finances since liberalization has been an expanded public investment program, directed at rehabilitating and expanding infrastructure in irrigation, power, and communications, which has been strongly supported by the international donor community on highly concessional terms. However, large unanticipated cost escalations seriously constrained the Government's resource capacity, and, on several occasions, the program had to be pruned down considerably. The overall budget deficit, which rose to 23 percent of GDP in 1980, is now expected to be scaled down to a more manageable 15 percent in 1983, of which nearly two thirds will be financed by highly concessional foreign assistance. Meanwhile, expansionary financing from the banking system has been pruned down from 10.6 percent in 1980 to 0.4 percent in 1983. A further reduction in the fiscal deficit is anticipated in 1984, to about 11 percent of GDP. My authorities feel that deficits of this magnitude are sustainable in view of the high level of foreign aid.

The considerable fiscal adjustment envisaged in 1983 is largely the result of a substantial mobilization of additional resources by enhanced tax measures, which are designed to reverse the declining trend of revenue as a ratio of GDP. The new measures are expected to generate the equivalent of 2.5 percentage points of GDP and increase revenue by 37 percent, not reckoning a transfer of Rs 1.5 billion of profits of the Central Bank to the Government, which is treated in the staff documents as an "exceptional transfer." This sharp increase in resource mobilization has to be understood in the context that the increase is expected over a nine-month period, on account of the delayed presentation of the 1983 budget. Measures of fiscal adjustment effected in 1983 included increases in prices of rice (7 percent), flour (15 percent), milk (25-43 percent), petroleum (13-34 percent), transport fares (25-48 percent), and fertilizer (26 percent). Rates for the Business Turnover Tax were raised by 2-5 percentage points and import duties by 2.5 percentage points for items taxed previously and by 5 percent for items previously exempt. Business Turnover Tax collections are to be speeded up. Transport fares were further raised in August 1983 by 500-100 percent on bus fares and by 10-30 percent on rail fares; the electricity tariff surcharge has been raised from 110 percent to 185 percent. Overgenerous tax incentives have been withdrawn, and the monthly indexation of public sector salaries has been frozen, to be reviewed semiannually. Capital expenditure has been further curtailed, well below previous years' levels, in real terms. No new projects will be admitted until 1984, and probably until the ongoing Mahaweli river diversion and power project is completed around 1985, by which time a better match between domestic savings and investment could be realized.

5. Monetary policy

The tightening of monetary policies since January 1981 is well documented in the staff reports. Following moderate fiscal adjustments, growth of public sector credit had declined from 42 percent in 1981 to 34 percent in 1982; under strong adjustment in 1983, it is expected to decline sharply to 4 percent in 1983. Meanwhile, private sector credit growth, which declined to 24 percent at the end of 1982, has shown signs of modest recovery in 1983, following restoration of business confidence, and marginal relaxation of credit, primarily aimed at promoting exports. My authorities consider this transformation to be prudent, in view of the gradual phasing down of the public investment program and the need to encourage the growth of the private sector. Although increased liquidity in the banking system arising from a deceleration in credit demand in 1982 did induce some moderation of interest rates, subsequent revival of credit demand has reversed the situation in mid-1983. Real interest rates have remained highly positive, and, although mindful of the impact of high rates on investment, my authorities propose to continue this policy.

6. Trade and payments

The current account of the balance of payments, which rose to 20 percent of GDP in 1980, has been scaled down to 15 percent in 1982, and is likely to be further reduced to 12 percent in 1983. Foreign aid inflows were sufficient to finance these deficits fully until 1980. Since then, however, some commercial borrowing has been made, which has not exceeded on average 2 percent of GDP a year. These borrowings have been made mostly for the national air and shipping lines, and for financing oil imports in the acceptance market. However small these borrowings may be in the overall debt structure, my authorities remain committed to exercising extreme caution in this regard, in view of the implications on debt service. Including IMF repurchases, the external debt service ratio rose to 19 percent in 1982. When inward private transfers--which should normally be reckoned as part of current receipts--are included, the ratio declines to 16 percent. It should be noted that a predominant portion of debt service is on account of highly concessional aid credits. My authorities believe that a current account deficit not including grants in the region of 12 percent in 1983, and 10 percent in 1984, are sustainable because of the high foreign aid absorption in the country, which is reflected in a higher level of imports, mainly of a capital nature.

7. Exchange system

My authorities and the staff have been successful in working out an agreed formula by which the deviations of the exchange rate from an acceptable norm could be measured, considering the special circumstances in the country. The movements of the effective exchange rate indices on this basis are illustrated in Chart 1 and Table 33 of the paper SM/83/186. It is interesting to note that the variations between the nominal and the real indices of effective exchange rates have narrowed considerably since 1980. Moreover, the exchange rate which showed some appreciation in 1982, has been depreciated strongly so far in 1983. In fact, the staff notes, in Supplement 1 to EBS/83/166, that the changes in the external value of the rupee have continued with the agreed formula, and that by end of August 1983 the value of the rupee had reached a level slightly more depreciated than the result of the agreed formula. This is evidence of my authorities' firm commitment to adopting a flexible exchange rate policy.

8. Recent disturbances

The impact of the recent disturbances has been assessed by a special report in Supplement 1 to EBS/83/166. At a time when Sri Lanka has been coming to terms with adverse external developments, the recent disturbances have caused further complications.

My authorities have promptly taken action to restore law and order; and I and the Fund mission, who visited the country recently, were surprised at the speed with which a return to normalcy is taking place. A large number of damaged industries could be made operational within a short time. Although the replacement value of the destroyed machinery has been tentatively established at about Rs 1,750 million, the actual restoration of activity may be achieved with a lower outlay, on account of the undesirability of replacing obsolete machinery, the cheaper cost of replacement by more modern technology, as well as the potential of fuller use of existing excess capacity.

In order to prevent unlawful occupation and distress of sales of damaged properties, my authorities have vested the affected properties in a special rehabilitation authority (REPIA), which is now in the process of divesting properties back to the owners/occupants, on their request. Where the owners are without resources to effect the necessary repairs, even after insurance compensation, and where they seek government assistance on concessional terms, the Government may wish to have a stake in the establishments, in order to ensure that public funds are properly utilized.

My authorities are in complete agreement with the diagnosis of the Fund mission that the basic parameters of the fiscal, monetary, and balance of payments outlook for 1983 will remain largely unaffected by the recent disturbances. This also reflects the firm determination of my authorities to adhere to the agreements reached with the Fund. The real impact of the recent disturbances may perhaps lie elsewhere, namely, in the cordial relations that have existed between different communities in Sri Lanka's multiracial society. My authorities are convinced that, as in the past, these difficulties can be overcome with continued goodwill and understanding.

9. Medium-term outlook

The proposed one-year stand-by arrangement, with financial magnitudes determined up to the end of 1983, is deemed a short-term adjustment effort aimed at bringing the economy back on track on a sustainable path of noninflationary growth, hence the heavy orientation toward demand management. However, my authorities are mindful of the need to rectify certain structural imbalances, and are now engaged in discussions with the World Bank on a structural adjustment loan. Moreover, my authorities are now formulating medium-term policies of a structural nature, which are identified in Section IV of EBS/83/166, and an early discussion of the issues could be envisaged during the mid-term review.

Mr. Hirao stated that he was in general agreement with the staff appraisal, and that he supported the proposed stand-by arrangement. Since 1980, partly due to the deterioration in the terms of trade and partly to expansionary financial policies, the current account deficit of Sri Lanka had been larger than could be financed by nondebt-creating aid flows. Substantial commercial borrowing abroad had worsened the external debt situation and increased the burden of interest payments. Pressures on the balance of payments had become particularly strong in the second half of 1982. Although the Central Bank had substantially increased its short-term foreign borrowing, in early 1983 gross official reserves had remained at the uncomfortably low level of two months' imports. Moreover, the outstanding external debt had increased to nearly 60 percent of GDP by late 1982. Clearly, far-reaching corrective measures to strengthen the external accounts would be needed.

Speaking on the proposed stand-by arrangement, Mr. Hirao dealt first with fiscal policy. Government revenue had declined steadily from 26 percent of GDP in 1978 to less than 17 percent in 1982, while expenditure had fluctuated widely from 28 percent to 43 percent during the same period, reflecting swings in public investment. On the revenue side, there had been heavy reliance on export taxes and a very narrowly based income tax. The new tax measures introduced in the 1983 budget were welcome. Nevertheless, he shared the staff view that there was still considerable room for further improvement in tax elasticity. The ratio of tax revenue to GDP in 1983 was estimated to be well below the level of 1978. The authorities would be well advised to consider a further expansion of the income tax base by eliminating a number of exemptions, and to improve the methods of collecting consumption taxes.

On the expenditure side, Mr. Hirao remarked, the authorities had made efforts to reduce both capital and current expenditure in the 1983/84 budget. The recent modification of the wage indexation system and the introduction of some expenditure control procedures were also to be commended. It was quite satisfactory that in those ways the Government would be able to avoid commercial borrowing abroad and virtually eliminate recourse to domestic bank financing in 1984. Problems did however still remain among the public corporations, budgetary support of which accounted for as much as 8 percent of GDP in 1983. Even though he could understand that the matter was a delicate one, especially in connection with the corporations providing social services and essentials to the low-income population, he supported the staff view that a comprehensive review of the operation of the corporations, particularly of their rigid pricing policies, should be completed as soon as possible. He had of course noted that measures had recently been taken to raise the administered prices of rice, milk, and petroleum products, certainly a move in the right direction. As to monetary policy, he supported the authorities in their aim to curb the credit expansion to the public sector while allowing sufficient credit to the private sector to sustain recovery. He was glad that commercial banks had been left relatively free to determine their own interest rates, thereby leading to active competition as well as to positive real interest rates. Unfortunately, there was still a problem with the National Savings Bank. The authorities would be well advised to take further steps to reduce the higher interest rates and the tax advantage offered for National Savings Bank deposits, in order to reduce the distortion in the financial system that they had been causing.

On the external side, Mr. Hirao observed, the main cause of the deterioration in the external position since 1977 had been the failure of exports to show any significant increase in volume or to diversify. Efforts in both those directions were essential if there was to be any durable improvement in Sri Lanka's external position. It was certainly encouraging that the authorities had determined to adopt a flexible exchange rate policy as a means of at least maintaining their present competitiveness. On the other hand, he shared the staff's concern that the various export incentives, whether tax rebates or credits, did run the risk of creating serious distortions over time. The authorities would do well to place emphasis on structural reforms to raise the productive capacity of the country for such major export items as tree crops and some manufactured goods. The output of tree crops had in general stagnated in recent years as a result of weak management of the plantations. He hoped that medium-term investment plans being prepared by public corporations would lead to a diversification of the output of tree crops. Manufacturing output for export had also been disappointing, largely because of the high tariff protection, which had favored import substitution and discouraged exports of many industrial commodities.

In conclusion, Mr. Hirao stated, he was glad that the authorities had shown so much commitment to the adjustment program. He was also glad that they had decided to adhere to the program for 1983/84 that had been decided upon before the recent disturbances.

Mr. Ismael commented that improvements in public finance, and the external sector, together with an increase in domestic savings and an improvement in their use were all vital if real economic growth in Sri Lanka was to be sustained over the long term with a reasonable balance of payments position.

The public finances of Sri Lanka, Mr. Ismael went on, were characterized by large imbalances. The authorities should therefore take measures to reduce the size of the fiscal deficit. He welcomed the steps that had been taken to improve the tax effort and to strengthen expenditure control. He was rather concerned that the burden of fiscal adjustment had fallen too heavily on the capital budget. The curtailment of the capital program could seriously jeopardize the growth objective of the Government. He would therefore have liked to see greater restraint in the operating expenditures. While he welcomed the steps that had been taken to improve the fiscal situation, and the measures contemplated for the future, a still greater effort was required. He did of course recognize that part of the problem was associated with the poor performance of the export sector.

As to the export sector itself, Mr. Ismael commented, it had been extremely weak, in part due to poor demand, but more particularly to inadequate incentives for producers and the bias in government policies against exports. The adoption of realistic exchange rate and pricing policies, a reduction in the level of protection for domestic industries, and an improvement in the agricultural infrastructure were surely vital. He noted with concern that agricultural development, especially the expansion of export crops, was hampered by weak institutional arrangements and a lack of credit facilities. He therefore welcomed the proposal under which the authorities had committed themselves to maintain a flexible exchange rate policy, adjusting the Sri Lanka rupee on the basis of the price performance of Sri Lanka relative to its major trading partners.

There were a large number of skilled and professional Sri Lankans working abroad, Mr. Ismael stated. While their absence had created a manpower problem at home, it had had a beneficial impact on the balance of payments. Emigrants' remittances constituted an important element in the balance of payments, and the authorities would do well to improve incentives to attract a greater inflow of remittances. The external debt service ratio, although not excessive at present, could become unmanageable unless appropriate policies were adopted. He therefore welcomed the way in which the authorities intended to move cautiously on contracting external debt, especially from the commercial market.

Finally, Mr. Ismael observed, the authorities should do all in their power to increase domestic savings as a means of sustaining public and private investment and reducing the fiscal deficit, as well as improving the balance of payments. The savings ratio in Sri Lanka had not been very high, and public savings had actually been negative. The incentives to private savings should be improved. The recent decision to liberalize interest rates on deposits was therefore a welcome step that should help to raise the productivity of capital. In addition, a major improvement in public finances would be required to generate public savings. The measures outlined in the proposed stand-by arrangement, together with those already taken, were adequate to strengthen the balance of payments of Sri Lanka. However, major structural adjustments would be needed, with the continued support of the Fund, the World Bank, and bilateral aid donors. In the circumstances, he could support the proposed decisions both for the 1983 Article XIV consultation and for the proposed stand-by arrangement.

Mr. Taylor said that, while he could support the proposed decisions, he had to admit to misgivings about the proposal for the stand-by arrangement. He was sorry to see that Sri Lanka had had to return to the Fund only two years after having successfully completed an extended arrangement. While to some extent Sri Lanka's misfortunes were the result of the events that had struck the economy in the past year or two, they also seemed to have been caused to some extent by overambitious macroeconomic policies. The staff had stated that the negotiated program was only a first step in the fundamental adjustment required by the situation. That was a discouraging judgment when it was remembered that major structural adjustments had been launched as far back as 1977 and had continued as part of the Fund adjustment program. In the circumstances, the authorities would seem to have little alternative but to redouble their adjustment efforts, particularly in the export field and in connection with the mobilization of savings. A determined effort to improve the fiscal position was a basic requirement of the adjustment strategy. He noted that the authorities' intention was to keep the government deficit below 15 percent of GDP during 1982/83 and to reduce it to 11 percent for 1983/84. While such an attempt was commendable, further efforts, in particular to restrain public expenditure, would be essential if the reliance on foreign or domestic bank financing of the deficit was to be kept within manageable limits. Too rapid an expansion of expenditure in 1982 seemed to be the immediate cause of much of Sri Lanka's present difficulties.

More particularly, Mr. Taylor observed, on the expenditure side the authorities should concentrate on eliminating or at least reducing subsidies and bringing about some further deindexation of public sector salaries. He would also endorse the staff's call for more comprehensive public expenditure control procedures. He hoped that the authorities would act promptly on the findings of the committee to review the tax structure. It would certainly be important to strengthen and broaden the tax base, so that fiscal revenue might be more resistant to a recession in activity.

As to monetary policy, he agreed with the staff that it should be used as a means of reinforcing the authorities' strategy for lowering inflation, Mr. Taylor asserted. Like earlier speakers, he had been disturbed to see from the staff's account of the National Savings Bank that its operations did introduce an important distortion into the financial system. Despite the 2 percent reduction in the savings bank deposit rate from earlier in the year, much of the generous margin over rates paid by commercial banks still remained. On the supply side, given the precariousness of the fiscal position, the authorities' decision to refrain from starting further development projects during 1983, 1984, and 1985 was probably realistic. Investments still represented 30 percent of GDP, a comparatively high figure that was one of the beneficial results of four years of structural adjustment.

The neglect of the tree crop plantations, Mr. Taylor considered, had resulted in a serious situation in an important sector of the economy; it probably explained a good deal of the disappointing export performance in that sector over the past few years. He hoped that the medium-term investment plans now in preparation would prove acceptable both to the authorities and to the World Bank. He urged the authorities to act quickly on the reports that they were about to receive from the enterprises, and to allow no slippage in the timetable for remedying the situation.

He certainly welcomed the authorities' commitment to their more flexible exchange rate policy, Mr. Taylor stated. He hoped that they would be prepared to adjust the rate downward from the level established in July 1983 if developments in the reserves and in the current account position suggested that the currency was still overvalued. The worry on the external side was the the debt service ratio, projected to reach 21.5 percent in 1983 and to continue rising until 1987 at least. While the figure was perhaps not very critical, it could easily become so if for any reason the progress in adjusting the current account slipped significantly. There might, for example, be a serious fall in the overseas remittances that flowed into the economy as a result of economic activity in the Persian Gulf area. The authorities would have to consider the question most carefully and take further measures if the situation required.

There was a possible loophole in the capital account arrangements, Mr. Taylor observed, in the sense that borrowing by residents was permitted from foreign currency banking units. Would it be possible to monitor those units more closely and to exert some control over such borrowing? The present arrangements could perhaps affect the behavior of short-term bank borrowing, a performance criteria under the proposed arrangement.

It was a wise precaution for the staff to have returned to Sri Lanka after the civil disturbances and before presenting its report to the Executive Board, Mr. Taylor said. Aside from the inevitable emergency expenditures, revenue also must have been affected. Although he saw that the domestic deficit was to be tackled mainly by slowing down capital disbursements, he would encourage the authorities to exercise fiscal restraint as far as possible, and to keep as closely as possible to the original fiscal targets so as to remain within the bank credit ceilings and other performance criteria. For the Board review to be completed by January 1984, he hoped that the staff would be able to conduct the review mission quite early, especially in view of the doubts that it might have about the authorities' projections, for example, on tourism and private transfers.

In supporting the proposal, Mr. Taylor concluded, he hoped that it would be possible to use the program as a means of retrieving the slippages that had emerged at the end of the previous program. If the authorities were to tackle the more underlying problems of the economy, they would need to take stronger action on the central issues.

Mr. de Vries stated that he too could support the proposed decisions. Sri Lanka had requested a rather modest drawing of SDR 100 million under a one-year stand-by arrangement, representing some 55 percent of quota. The drawing was justified, as was the modesty of the amount. The authorities were making only a modest adjustment effort, especially if it were examined in the light of what would be needed to establish a comprehensive program. The program was fully in line with present policy on the use of the Fund's resources.

Although the shift of policy in 1977 had been successful, Mr. de Vries went on, it had been brought to a halt in 1980 and not yet fully resumed despite the reaffirmation of support for the policy in recent elections. Both the staff and Mr. Jayawardena had spoken of the stand-by arrangement as a first step of the adjustment effort, and there was some hope for a World Bank structural loan. Both the Fund and the Bank seemed to hold out the expectation, if not the promise, of a medium-term structural adjustment program at the mid-term review. He had not been so dismayed as Mr. Taylor by the fact that Sri Lanka was returning to the Fund after completing an extended arrangement, under perhaps more stringent credit policies. The Fund's holding of Sri Lanka rupees in the credit tranches amounted to 150 percent of quota, which would be raised to 200 percent of quota if the proposed decision was approved. He viewed the present request as preparing the ground for more favorable developments. The authorities had shown in the past that they were quite able to mount a program that would bring about dramatic changes in the economy.

As to the program itself, he agreed with most of what Mr. Hirao had said, Mr. de Vries observed. The aim was to reduce the budget deficit from 23 percent of GDP to 15 percent and the current account deficit from 20 percent to 12 percent in 1983. In the other direction, the debt service ratio was expected to move from 19 percent of GDP in 1982 to 60 percent by 1987. Although there were dangers, the figures seemed to be moving in the right direction, and if in fact it proved possible to move the current account deficit to 10 percent of GDP in 1984, the situation would be placed on a far more sustainable basis. Much of the action needed to improve the budgetary situation had been taken, but the staff mentioned the need for more comprehensive expenditure controls, and a great deal of attention might be required to the practices of the public corporations. He was glad that the authorities did not intend to engage in major new infrastructure projects until the large Mahaweli river project was completed.

More generally, he wished to support the staff in recommending that the authorities should prepare a more comprehensive investment strategy, Mr. de Vries declared. They needed to take steps to mobilize domestic savings, to improve the running of the government plantations, and to deal with protectionism. In the recent past, the output both of the plantations and of manufacturing had been disappointing. Mr. Jayawardena had given an interesting description of the difficulties in the plantations, largely arising from public sector management, and he had mentioned that estate-by-estate development plans were being prepared. He hoped that the new system, involving new incentives for workers and managers, would bring about increased efficiency. As to manufacturing, it seemed clear that a complicated tariff protection structure provided the wrong sort of incentives. The proper incentives, together with a realistic exchange rate policy ought to help to make the manufacturing sector more export-oriented. Regarding the exchange rate, Chart 1 of EBS/83/166 seemed to show a rather substantial appreciation of the currency in real terms from 1979/80 until about the middle of 1982, and a relatively small reversal since that time. More attention was probably required to the exchange rate; in any case, he was encouraged by the intention of the authorities to adopt a more flexible exchange rate policy. He looked forward to a proposal for a medium-term program at the time of the mid-term review.

Mr. Prowse stated that he supported the main elements of the staff proposal together with the proposed decision. The staff described the program as providing a first step toward the required adjustment effort, and, like others, he accepted the staff description as a sufficient basis for a relatively modest purchase. He did however note that the program was being described as a first step after a fairly lengthy period of Fund assistance, and he would have hoped for something more. He would also have liked to see the adjustments to policy described with greater clarity and precision.

While real growth in Sri Lanka had been fairly satisfactory since 1977, Mr. Prowse went on, continuation of growth at any satisfactory rate would depend on the adoption of an appropriate fiscal policy, with greater stress on the mobilization of domestic savings, including the contribution of revenues by the public corporations. While the authorities had reformed the tax system, the staff view was that there was still ample scope for a further increase in the tax effort. What was unfortunate was that the Board had noted exactly the same situation one year previously. While he agreed that the focus of the program should be on fiscal restraint, it was hardly possible to say that a program that led to a budget deficit of 11 percent of GDP in 1984 represented much progress, even if the deficit was to be financed from abroad on concessional terms.

On the external side, he saw that the current account deficit was still to be in the neighborhood of 10 percent of GDP in 1984, a figure that he did not consider viable, Mr. Prowse stated. The ratio of debt to GDP had increased steadily, and the debt profile had deteriorated, with a significant increase in short-term debt and a decline in the concessional element. In August 1982, the Executive Board had emphasized the need for great caution in external debt. In the circumstances, he wondered whether those Directors who liked to stress the need for commercial borrowing as being preferable to borrowing on concessional terms through the multilateral organizations were always correct. Indeed, if Sri Lanka had carried out less commercial borrowing and rather more borrowing under program guidance, the situation might well be somewhat better.

In the budget, Mr. Prowse noted, expenditure on wages and salaries was apparently to increase by 13 percent in 1982/83. Surely the authorities ought to understand the importance of maintaining restraint on real wages in the public sector. Unless they did so, the long-term prospect of fiscal restraint would be in jeopardy, a point also made by the Executive Board in 1982.

He would be interested to know, Mr. Prowse stated, where the staff stood on the matter of the exchange rate. While he could agree that flexibility was desirable, the Sri Lanka rupee had generally been appreciating since 1978. Did the staff believe that the present rate was broadly satisfactory? Did it provide a sufficient incentive for exporters, particularly those selling the produce of tree crops?

While he was prepared to support the decisions, Mr. Prowse reiterated, he would have been more encouraged if the policies referred to by the authorities had actually been in place. Similarly, the staff seemed to be satisfied that the authorities were preparing medium-term investment plans, marking the first serious attempt at tackling the inefficiencies in the sector. Such a position would be acceptable only because the purchase was modest and because a major review would be held in the near future. Similarly, the staff could have asked for more in connection with procedures for controlling public expenditure and in the financial situation of public corporations. He endorsed in the strongest terms the statement by the staff that bold decisions on the pricing, management, and size of the activities of public corporations should no longer be postponed. He hoped that when the Fund mission held discussions with the authorities in the not too distant future, it would exert its best efforts toward obtaining clarification of the authorities' policy in those important areas.

In conclusion, Mr. Prowse emphasized that his comments were only offered by way of assisting the staff in further discussion. They did not in any way detract from his support for the decisions before the Executive Board.

Mr. Zhang stated that he fully supported Sri Lanka's request for a one-year stand-by arrangement. Nevertheless, he would like the staff to clarify one point. He had been surprised that in the proposed stand-by arrangement--lasting only for one year--which should involve mainly demand management and stabilization measures, the staff had considered it proper to include understandings on structural adjustment. As he understood it, according to Fund practice the kind of structural adjustment referred to by the staff should ideally be undertaken as part of a medium-term program. He wondered therefore why the staff had included the understandings in a one-year stand-by arrangement instead of concluding an extended arrangement. Would the staff do the same thing again in a similar situation? On the matter of savings, he would be interested to know, first, whether the rather even distribution of income in Sri Lanka had affected the rate of savings. Second, the level of profits remitted abroad by the multinational corporations had been rather high, he wondered whether that factor had affected the rate of domestic savings in Sri Lanka in any significant way.

Mr. Suraisry said that he too generally agreed with the staff's main conclusions. He commended the authorities on the progress that they had made in revitalizing the economy over the past five years. Investment had been buoyant, economic growth had been strong, and unemployment had been hard. Nevertheless, difficulties remained. A combination of over-expansionary financial policies and worsening terms of trade had led to a growing budget deficit, renewed inflationary pressures, and widening imbalances in the external accounts. At the same time, the authorities had only had limited success in dealing with structural weaknesses, notably in the traditional export sector. The authorities recognized the need for adjustments in many areas, and he supported the request for a stand-by arrangement.

The stabilization program agreed with the Fund was both comprehensive and convincing, Mr. Suraisry considered. It had at least two particularly encouraging features. First, the authorities had a good record of cooperation with the Fund, and virtually all the necessary demand management measures were already in place. Second, the authorities remained firmly committed to the program despite the recent disturbances, and they were taking swift action to reconstruct the economy. More specifically, he agreed with the staff that the main focus of adjustment in the short term had to be on the fiscal side. He therefore welcomed the recent tax measures, which should help to reverse the decline in the ratio of tax revenue to GDP. He also welcomed the moves to limit current expenditures, in particular the decisions to freeze public sector hiring and to replace the system of monthly wage indexation with semiannual adjustments. The authorities' determination to adhere to strict financial discipline was commendable. To be effective, fiscal restraint would need to be accompanied by cautious monetary policies. In that respect, the proposed credit ceilings seemed appropriate, and they should also provide adequate scope for channeling credit to the private sector. The intention to reduce, and then eliminate, domestic bank financing from the budget deficit was fully in line with the objective of containing inflation. He would encourage the authorities to press ahead with efforts to expand the domestic capital market. Externally, he fully supported the objective of reducing the current account deficit to a more sustainable level, while maintaining an open trading system. Although the debt service position was manageable at present, the authorities were clearly right to take a prudent stance in that connection. He also welcomed the steps being taken to improve debt management and to monitor the related procedures.

In short, Mr. Suraisry remarked, the program for 1983/84 should provide a sound basis for sustained growth over the medium term. It was encouraging that the authorities were tackling the deep-rooted problems in the economy, in conjunction with the World Bank. The recently revised public sector investment program seemed more in line with available resources, and he fully endorsed the emphasis on quickyielding export-oriented projects. He also welcomed the moves to rehabilitate the tree crop sector and to promote export diversification. As the staff had mentioned, an improvement in the tree crop sector would require the provision of appropriate incentives to producers of tradable goods. He therefore hoped that the authorities would be able to reduce the tariff rates as planned in the 1983 budget. New efforts might also be required to mobilize domestic savings, particularly in the public sector. The proposals under consideration for reforming the tax structure, developing more effective expenditure controls, and strengthening the financial position of the public enterprises were all steps in the right direction. Sri Lanka certainly had a difficult task ahead. The authorities had however been acting firmly to deal with the imbalances facing them, and the prospects for meeting both their short-term and their medium-term objectives seemed reasonably good.

Mr. Kabbaj observed that, despite severe economic difficulties, including the emergence of large domestic and external imbalances, the performance of Sri Lanka since the far-reaching reforms of 1977 had in the main been satisfactory. The 1977 reforms had aimed at a smooth transition from a stagnant state-controlled economy to a largely market-oriented one, in which the private sector would play a larger role and economic adjustment would be sought through financial and monetary instruments rather than administrative regulations. Supported by a one-year stand-by arrangement and a three-year extended arrangement, the reforms had resulted in a substantial improvement in economic performance, with the doubling of both the rate of investment to GDP and the annual rate of economic growth between 1977 and 1982, with a sharp decline in the unemployment rate, the containment of inflationary pressures, and a considerable expansion of infrastructure.

Nevertheless, Mr. Kabbaj noted, despite the authorities' adherence to the 1979/81 Fund program, the effective implementation of all the announced policies, and the meeting of various performance criteria, Sri Lanka's economy had experienced a sudden and rapid decline during the past two years. While the unfavorable developments had been due to adverse exogenous factors, including the depressed world economic environment, weak demand for Sri Lanka's traditional exports, a sharp deterioration in the terms of trade, and disastrous weather conditions, it could hardly be denied that the deterioration had been aggravated by the appearance of bottlenecks on the production side as well as by an easing of demand management policies, and by the postponement of decisive adjustment action, for understandable reasons.

The liberalizing reforms carried out in cooperation with the Fund had been among the most important issues of the recent elections in Sri Lanka, Mr. Kabbaj recalled. It was encouraging to note that the authorities' strategy and policies had been unequivocally endorsed by the electorate. Equally encouraging had been the corrective measures taken in February 1983, aimed in particular at improving the adjustment process, and at containing both the fiscal and the balance of payments deficits. Among the most notable of the measures had been the 7 percent devaluation of the Sri Lanka rupee against the U.S. dollar, the upward adjustment of administered prices, the adoption of new tax measures equivalent to 2.5 percent of GDP, and the reduction in growth of capital expenditures. However, the improvements from the implementation of those measures had been far less than needed, and the necessity of further measures had become evident shortly after the adoption of the 1983 budget. He welcomed the Sri Lanka authorities' decision to adopt a stronger program and a more decisive attitude toward adjustment, and to seek Fund support for their efforts. While he supported the new request for a use of Fund resources by Sri Lanka, he noted that the amount was small in terms of quota, considering the comprehensiveness of the program accepted by the authorities in relation to the Fund's holdings of Sri Lanka rupees and the country's satisfactory record of cooperation with the Fund. He did however note that the requested stand-by arrangement was regarded as only the first step in the fundamental adjustment required.

As to the program for 1983/84, Mr. Kabbaj observed that the authorities intended to adopt comprehensive policies, with particular emphasis on the need to alleviate the financial imbalances, to reduce monetary expansion, and to implement more flexible pricing and exchange rate policies. Furthermore, the program provided for a start of reforms aimed at correcting structural weaknesses in public investment, state plantations, and taxation. He was grateful to the staff for the supplementary information circulated during the previous week to update the initial report in the light of recent disturbances. The authorities had acted with commendable speed to contain the effects of such incidents, and he welcomed their firm intention to carry out all previous commitments.

Mr. Finaish remarked that since 1977 the Sri Lanka authorities had carried out significant reforms that had contributed to an improvement in the economic performance. The growth rate had doubled, the investment ratio had risen considerably, self-sufficiency in rice had been achieved, and the unemployment rate had been halved. Recent difficulties--resulting from a combination of global recession, bad weather, and some policy slippages--had increased the country's foreign borrowing and hence the debt service ratio and put pressure on the foreign reserves. In an effort to steer the economy back to a desirable long-term growth path, the authorities had already put into effect several corrective measures, and had approached the Fund for a stand-by arrangement. To achieve durable and noninflationary growth, considerable emphasis had been laid on the reduction of the fiscal deficit and the maintenance of monetary restraint. The financial program, while tightening monetary policy, had sought to reduce public sector credit. Government expenditure would be reduced principally by curtailing public investment, and by a moderation of wage indexation in the public sector. His comments on the subject of curtailing public investment were similar to those of earlier speakers.

The staff was, however, correct, Mr. Finaish went on, in remarking that the negotiated program was only a first step in the fundamental adjustment required by the situation. Gains from stabilization would be secured only by the implementation of far-reaching structural measures to promote investment, augment public sector efficiency, increase the elasticity of the tax system, and mobilize domestic savings, and by the maintenance of fiscal discipline in the long run. In particular, the authorities should push ahead with plans to salvage the neglected plantation sector, since traditionally tree crops had been the backbone of the economy. He was glad to have heard Mr. Jayawardena say that emphasis was being placed on that issue by the authorities.

On the external side, Mr. Finaish noted, the authorities intended to maintain a flexible exchange rate policy and to limit their external indebtedness. In connection with the exchange rate policy, he would be interested to hear the staff reply to the point raised by Mr. Prowse. The authorities had anticipated a decline in the current account deficit from 15.3 percent of GDP in 1982 to 10.5 percent of GDP in 1984. Table 10 in EBS/83/166 showed that the authorities expected large fluctuations in export prices and the terms of trade. To what extent, he would like to know, would such large fluctuations make the predictions uncertain, and hence the attainment of program targets difficult? He fully supported the proposed request.

Mr. Laske said that he agreed with many of the comments already made, especially those by Mr. Prowse and Mr. Taylor. On other points, however, he had a rather different point of view. Since the most recent Article IV consultation with Sri Lanka, the country had been adversely affected not only by unfavorable weather but also by weak foreign demand and political disturbances. He had been relieved to learn from the staff that the repercussions of the disturbances had not been as disastrous as might have been feared. Nevertheless, during 1983/84 growth would be more than half of 1 percentage point lower than had been projected. The expected 4 percent outcome was substantially less than the medium-term objective considered desirable by the authorities if they were to maintain per capita income and provide enough jobs for a growing population.

Unfortunately, Mr. Laske went on, the evidence seemed to show that the slowdown in growth was not primarily the effect of exogenous forces over which the authorities had no influence. When, in 1977, a new direction of policy had been adopted, one major characteristic had been the rehabilitation of the tree crop plantations, the most important export-earning sector. However, relatively little action seemed to have taken place in that respect. Moreover, in other sectors, structural adjustment had fallen far short of expectations, even under the extended arrangement with the Fund from 1979 to 1981, and the present staff paper (EBS/83/166) made it clear that structural adjustment ought to be accelerated. Moreover, there appeared to have been some slackening of determination in the conduct of demand management policies during the past two years. Such policy shortcomings had contributed significantly to the imbalances that now needed to be corrected, and to the uncomfortable financial situation that the authorities were facing.

Commenting more particularly on the measures taken by the authorities in the wake of the domestic disturbances, Mr. Laske noted that the authorities had decided to take over the property affected by the disturbances through a special authority established for the purpose. His concerns about the potential financial consequences of the measure had been relieved when he had read that the property would eventually be returned to the original owners. Nevertheless, for properties that had suffered particularly severe damage, the Government might decide to become financially involved for a rather long period. In view of the precarious state of the Government's finances, such an action should be only a last resort, and should only be implemented when an early disengagement on the part of the Government was in prospect. As the Task Force had recommended, it would be unwise to rehabilitate industries that had not performed well over protracted periods or that contributed to the existence of excess capacity. In any event, the financial commitment by the Government should be kept as small and as temporary as possible.

The program for the stand-by arrangement consisted of two parts, the demand management part and the structural adjustment part, Mr. Laske said. He had already said how disappointed he had been with the slow progress made since 1977 in correcting basic maladjustments in the economy. His expectations for speedier progress henceforth were very high.

Both the staff and the authorities had correctly identified the action required, Mr. Laske noted; unfortunately, little immediate action appeared to be contemplated. He was rather surprised at the lack of results because the shortcomings, particularly in the tea plantations, had been known for several years. While paragraphs 5 through 10 of the letter of intent did give a good sense of direction, some definite activity in a number of important fields was still only in the analytical or planning stage. He would therefore attach great importance to the mid-term review, which should ensure that continuous progress was being made. On previous occasions, a number of Executive Directors had warned the authorities against the risk of overambition in the public investment sector. It was therefore only logical that the investment sector was being cut back to what could be sustained both physically and financially.

It was particularly regrettable, and a matter that needed urgent correction, that the public sector had contributed only negatively to domestic savings since 1978, with the possible exception of a single year, when public sector savings had been positive by a small proportion of GDP, Mr. Laske remarked. He therefore welcomed the decision of the authorities to carry on in 1983 and 1984 only with those investment projects that were already being executed. In that regard, he wondered whether he had detected a small discrepancy between the staff report and the letter of intent. The staff report on page 19 said without qualification that no new project would be started in 1983 and 1984. Paragraph 8 of the letter of intent, however, stated that during 1983 and 1984 no new work would be started on any project besides those already included in the plan. He hoped that the language in the letter of intent did not conceal investment intentions that would overburden the real economy, the public finances, and the availability of savings both domestic and foreign. Once the Mahaweli Project had come into operation, the scope for additional investment might increase; until then, restraint would have to be exercised.

The demand management section of the program was satisfactory, Mr. Laske considered. All the important aspects were covered. He was particularly pleased about the more realistic approach to exchange rate policy and to interest rates that had been adopted by the authorities. After the exchange rate had moved in the wrong direction for some time, the authorities' present commitment to maintaining international competitiveness was important. On that topic he had had similar thoughts to those of Mr. Prowse and Mr. de Vries. A check on the behavior of the effective exchange rate should be one of the major elements in the midterm review. He was also pleased to see the authorities' more liberal interest rate policy, which had allowed positive real rates to emerge. Nevertheless, like the staff, he was disturbed about the distortion introduced through the operations of the National Savings Bank, whose privileged position in tax matters had given it a competitive edge. What was particularly worrying was the National Savings Bank's function as a financier for the budget on the one side and as a drain on the budget because of its operating losses on the other. The National Savings Bank seemed to be paying subsidized interest rates to attract funds for the Government, thus crowding out private borrowers who could have a larger role in the future development of the economy. He would like to hear staff comments on whether the small changes introduced earlier in 1983 had altered the situation fundamentally.

The adjustment measures adopted by the authorities during the past 18-24 months had not been as strong as the situation required, Mr. Laske remarked. As a consequence of the obvious reluctance to set prices in accordance with world market developments, subsidy payments had arisen with detrimental effects on the financial position of the respective public enterprises. He was glad that the authorities had revised certain prices upward earlier in the year. Nevertheless, the declared intention to do more in the same direction later in the year was rather weak. In view of the unsatisfactory performance of the public sector finances as a whole, he would have preferred a clear commitment by the authorities, or even prior action. He strongly urged the authorities to translate their intentions into specific measures before long. Naturally, pricing policies alone would not turn the loss-producing public enterprises into profitable units. The staff report contained several hints regarding obstacles of a structural or administrative nature. The requirement of cabinet approval for certain pricing decisions might be rather cumbersome. Such decisions should ideally be taken on commercial grounds, for the purpose of covering the operating costs of the enterprises concerned. Further delay in reorganizing inefficient public enterprises and in putting pricing on a nonpolitical footing might well be fatal to the eventual success of the authorities' adjustment effort.

He was also concerned by the budget situation, Mr. Laske stated. Even though improvement was planned for the present year, the financing of the deficit remained in a precarious position. Although in past years foreign financing had been confined to concessional aid, commercial borrowing had assumed quite significant proportions in 1981 and 1982, thus indicating a departure from the more prudent earlier fiscal policy. Even though the overall deficit would represent a smaller percentage of gross domestic product in 1982/83 than in 1981/82, the need for substantially larger commercial borrowing abroad signaled the desirability of stronger fiscal measures on both the revenue and the expenditure sides. The staff had concluded that there was scope for further tax efforts, thus indicating some measures of dissatisfaction with the authorities' present policies. He strongly hoped that the budget for 1984/85 under preparation would envisage a larger reduction of the overall deficit and lead to a positive contribution to national savings.

As to structural adjustment, Mr. Laske maintained, consideration should be given to a reduction of the heavy reliance on foreign trade-related taxes. The increase in import duties contained in the present year's budget certainly helped to contain the deficit; it also accentuated the potential volatility of tax revenues. He did realize that domestically based sales taxes had contributed an increasing share to tax revenues since the late 1970s, but the basic revenue structure needed still further alteration. Eradicating the prevailing weaknesses from the tax collection system should also be considered a high priority item.

Although the current account deficit was expected to decline quite substantially, both in nominal terms and as a percentage of GDP, Mr. Laske noted, it would still remain uncomfortably high, especially when the increase in external indebtedness that the financing of the deficit would require was taken into account. Moreover, some of the projections might be on the optimistic side. To the items mentioned by the staff--receipts from tourism and from workers' remittances--he would add export receipts, which might be subject to downward revision because of the structural weaknesses in the agricultural sector and in the manufacturing industries. Because of the composition of Sri Lanka's basket of export products, unfavorable developments in the terms of trade were always a potential threat. Although the present level of external indebtedness did not necessarily give rise to immediate alarm, strict prudence was certainly necessary for the future. As the availability of development aid was not unlimited and more commercial borrowing was risky, stronger measures to contain the current account deficit seemed unavoidable. In passing, he had been rather surprised to read that the extension of loans denominated in foreign currency by foreign banking units in Sri Lanka was difficult to monitor, although such loans were subject to approval by the authorities. He would be interested to hear a comment on the point.

To bring Sri Lanka back to a sustainable payments position would require more than perseverance in demand management, Mr. Laske considered; it would also require determination in correcting the serious maladjustments in the structure of the economy and of the incentive policies. The staff had said that the proposed program would be only a first step in a multiyear effort. He therefore asked, first, in which category of adjustment programs the case of Sri Lanka would fall, according to the criteria for the scale of access that the Executive Directors had been discussing recently, Second, he wondered how the staff would proceed after the conclusion of the present program, which he hoped would be successful. The adjustment of the Sri Lanka economy had barely begun, and the adjustment progress envisaged for the stand-by period was not as much as he could have wished. His authorities therefore had reservations about the appropriateness of the arrangement, and they doubted whether it would provide for measures to begin an effective correction of an almost untenable situation.

Nevertheless, he would not withhold support from the program, hoping that on the present occasion the authorities would be more successful than in the past.

Mr. Erb remarked that the Sri Lanka economy had made considerable progress since 1977, much of which could be attributed to the more market-oriented policies followed since that time. Nevertheless, on the occasion of the previous Article IV discussion with Sri Lanka, he had expressed his concern with what he had perceived to be a substantial deviation from the previously laudable policy path; he had strongly urged the authorities to reinstate the kind of macroeconomic policies that they had shown themselves capable of conceiving and implementing. As he had feared at that time, Sri Lanka once again found itself in a serious financial situation. While measures were being taken to make the exchange rate more competitive, to mobilize domestic resources, and to restrain government expenditures, serious problems still needed to be resolved. He agreed with the staff that the stabilization of the economy over the medium term would be possible only with the timely implementation of structural policies whose objective would be to improve investment strategy, to eliminate effective protection, to strengthen the operation of government plantations, and to increase domestic savings mobilization. A continuing commitment to fiscal discipline would also be needed. He was glad to note that discussions had begun with the World Bank on structural reforms, which would be supported by a structural adjustment loan. The next steps in the structural area needed to be supported by other financing of that sort.

In addition, Mr. Erb went on, there were structural adjustments that the Government could make without any external financing. Indeed, such steps would probably lead to reductions in the external financial requirements, as well as to improvements in the potential growth rate in the domestic economy.

Regarding the proposed adjustment program, Mr. Erb remarked that the authorities had been slow to adjust the exchange rate for the Sri Lanka rupee, a delay that had probably contributed to the slowing of export growth. He welcomed the recent adjustment of the exchange rate, and he hoped that the authorities would pursue a more flexible policy in the future. He shared the staff's concern regarding the distortions created in the economy by the tax and subsidy measures designed to stimulate exports in the short run. He would also encourage the authorities to eliminate in due course the high import duties, as they tended to encourage inefficiency by protecting some domestic industries from foreign competition. He urged the authorities to move rapidly to implement the tariff recommendations expected in October, on completion of the special tariff study.

As to fiscal policy, Mr. Erb stated that he believed that it was crucial for the authorities to bring the large budget deficit under control as rapidly as possible. He urged them to try to achieve an even lower deficit in terms of GDP during 1983/84 than the current target of about 11 percent. Every effort should be made to improve the elasticity of the tax system and to devise more comprehensive public expenditure controls. He was glad to note that credit policies were to be appropriately restrictive. Vigilance was called for, and he agreed with the staff that monetary and other policies should promptly be tightened if the inflation and balance of payments objectives were to be reached. On the subject of domestic savings, he was concerned by the relatively low ratio of savings to GDP, and by the consistently negative public savings record. The maintenance of positive real interest rates should over time lead to increased private savings.

On balance, he could support the program, Mr. Erb remarked. As noted by other Executive Directors, the Fund's financial commitment was reasonably low. He also attached great importance to the review in January 1984 of the fiscal budget for 1984/85. At that time it should be clear, both to the authorities and to the staff, what the implications would be of recent domestic developments.

The staff representative from the Asian Department dealt first with the observation by several Directors that the program was being regarded by the staff as a first step in a renewed adjustment effort. While major changes had been made in the economy of Sri Lanka since 1977--the creation of a free trade system, the introduction of a freer exchange rate mechanism, and a considerable reduction in consumer subsidies--leading to the establishment of a climate where investment and production decisions could be made freely, the staff had also noted the weaknesses that had become embedded, especially in structural policy. The authorities had found themselves unable to move into the second stage of liberalization. While he understood the misgivings of some Executive Directors regarding the content of the present proposed program, notably that several structural policy aspects had not been covered in the program, they should realize that in the negotiations the staff had had to start from an economic situation as it had been at the time of the negotiations.

In reply to Mr. Zhang, who had asked why the staff in a one-year stand-by arrangement had required commitments from the authorities in the form of structural policies, the staff representative explained that many Fund stand-by arrangements did request commitments for structural policies. After all, most stand-by programs contained commitments by the authorities on such areas as exchange rates, interest rates, and pricing policies that were clearly policies of a structural nature. In Sri Lanka, the staff had felt that the main objective of the present program was to stabilize the economy. However, unless stabilization were soon accompanied by policies of a more structural nature, there was little chance that the adjustment that was the main aim of the program would be achieved. Indeed, it would have been difficult for the staff to guarantee the revolving character of Fund resources without such commitments from the authorities on the structural side. The authorities had agreed to that reasoning and had, indeed, begun to undertake the studies that clearly had to precede action in structural matters. Some of them would no doubt be delayed, by the recent events, and the mid-term review would be particularly important in reviewing progress in those areas. The Fund staff would be in Colombo in November at the same time as a World Bank mission that was going to initiate negotiations for a structural adjustment loan. He hoped that at that time the staff would receive from the authorities assurances that more than studies were being made, but also that important aspects of structural policy were being put in place, particularly in connection with the plantations and moves toward the elimination of some of the greatest anomalies in the protective tariff system.

Commenting on public corporations' performance in Sri Lanka, the staff representative agreed that they represented a great weakness, some of it brought on by past investment mistakes, by problems of management, and by faulty pricing and labor decisions. The authorities were reviewing the situation, and at their request the World Bank was just completing an industrial policy paper. Some of the recommendations of the IBRD were likely to be far reaching, including the divestiture of certain units to the private sector, or even the closing down of some units after a further trial period. Clearly, the topic was politically sensitive for the Government, but the authorities were committed to making improvements in the situation.

Another question, the staff representative recalled, had been whether there was scope for increasing taxation. The tax system was characterized by two weaknesses: first, it was insufficiently elastic because of many exemptions, the specific nature of several taxes, and the difficulties of tax administration; second, it created distortions. Because of those weaknesses, there was a clear need and ample scope for more tax effort. The authorities were reviewing the wide range of import tariff rates, and the review should be completed by the time of the Fund mission's visit to Colombo, so that important distortions could be reduced. It was hoped that the budget for 1984/85 would contain proposals to increase the buoyancy of the tax system. For instance, the authorities had already announced that government imports, which were currently not taxed, would be taxed in 1984/85, and that the most important anomalies in the tariff system would be corrected. But more was obviously needed.

Some Executive Directors had regretted that the brunt of the adjustment process was falling on the public investment program, the staff representative mentioned. At the time of the 1982 Article IV consultation with Sri Lanka, there had been a discussion between the authorities and the staff as to the size of the program. The Fund staff and the World Bank staff still believed that the public investment program had been too large, and that its relative share should be cut back, if only because there was a shortage of the necessary skills in Sri Lanka; the staff had noted that, both in 1982 and in 1983, actual implementation of the investment program had fallen far short of intentions, perhaps an indication that such a program was too large. The authorities, as part of their investment strategy, now wished to reduce the relative size of total investment in GDP and to provide more scope for the private sector. At a time when it was difficult to generate savings rapidly, public investment programs would have to be restrained. Moreover, one of the causes of weakness on the production side had been the lack of proper maintenance in plantations, for example. Therefore, it would be unwise to accelerate the public investment program when it was not possible to maintain existing assets adequately. There was no difference between the staff view and the views of the authorities regarding the moratorium on starting new projects. In fact, no new projects were to be started that had not been included in the plan a year previously. Consequently, there would be no additions to the investment program, apart from some reconstruction of damage caused by the recent disturbances.

As to monetary policy, the staff representative noted, considerable concern had been shown about the operations of the National Savings Bank. The National Savings Bank was the channel through which the budget obtained funds from small savers. There were several weaknesses in the operations of the bank, one of them being that the interest paid to depositors--plus the tax advantages attached to such incomes--was too high compared with the interest rates offered by commercial banks as well as Treasury bill rates. The recent reduction by 2 percentage points in National Savings Bank rates and the increase in interest rates by commercial banks since mid-1982 had reduced such distortions slightly. However, the difference in interest rates between National Savings Bank and other financial institutions was all the more important because it permitted a large shift of deposits from the commercial banking system to the National Savings Bank, which complicated the task of monetary policy. The matter had been discussed with the authorities, and particularly with the Central Bank; they were aware of the difficulty of establishing a monetary program in light of the rather considerable shifts to and from the National Savings Bank that were likely to occur. The authorities were trying to collect appropriate data so that a comprehensive financial survey could be established, which would help in setting monetary policy. For the time being, however, the National Savings Bank was not part of the monetary survey.

As to the external sector, the variability in terms of trade of the past years did not seem likely to affect the projections for 1984, the staff representative remarked. The substantial increases in average export prices included in the program for 1984 seemed quite moderate to the staff. Based on recent information regarding prices attained at tea auctions in Sri Lanka, the average price of tea for the first two quarters of 1983 had been 55 percent higher in foreign currency terms than it had been during the previous year, and all indications were that tea prices would remain firm in 1983 and 1984. If so, the export price assumptions of the program were on the low side.

Some Executive Directors had raised questions about the staff's attitude to the exchange rate, the staff representative recalled, especially in the light of the large appreciation in the real effective exchange rate between 1978 and 1982. In recent years, there had been discussions between the Sri Lanka authorities and the staff not only on the level of the exchange rate but also on the conduct of exchange rate policy. For the present program, the staff and the authorities had agreed on a principle of exchange rate management by which inflation differentials between Sri Lanka and its main trading partners would be offset through exchange rate action. Clearly, the formula was only as reliable as the price data used in measuring inflation for Sri Lanka, corrected for measured costs of production. For the time being, the present exchange rate level, together with the relatively high prices received for tea and rubber on the world market, had made the exports of primary commodities profitable once again. However, it would take some time to assess precisely whether the existing policy would be sufficient to encourage all exports. In assessing the adequacy of exchange rate policy, what was important was not whether the rate was in conformity with a formula, but whether a given exchange rate level and/or a given exchange rate policy made it possible to reach the broader objectives such as the growth of exports, the diversification of production, the maintenance of equilibrium in the current account of the balance of payments, and the strengthening of the reserve position. For the time being, there were both large import duties and export taxes in Sri Lanka as well as a multitude of export incentives. However, when those incentives were rationalized and import duties and export taxes reduced, as they would have to be in due course, the adequacy of the exchange rate for the rupee would certainly have to be reviewed not only in the light of such changes, but also of other objectives such as the budget position. The topic of the adequacy of the present exchange rate policy would in any event be taken up at the time of the mid-term review.

An Executive Director had asked a question regarding the exclusion from the debt ceiling of lending to private residents in Sri Lanka by foreign currency banking units, the staff representative mentioned. The staff had at first intended to bring that type of lending under the ceiling, but then found that there were practical reasons for not doing so. First, while the Sri Lanka authorities knew the amounts of authorizations granted to residents to borrow from foreign currency banking units, they did not know when the disbursements would materialize; all the components of short-term debt ceilings under the program were based on disbursements. It would therefore have been difficult to set reasonable limits mixing disbursements on the one hand and commitments on the other. However, the matter had been brought to the attention of the authorities, who had commissioned both the Commonwealth Secretariat and the World Bank to look into ways of improving the monitoring of those debts, so that the statistics of disbursements could be brought more up to date. Another issue in the operations of foreign country banking units was a possible mismatch of maturities between the deposits and the assets of such banking units that would also need looking into.

Continuing, the staff representative recalled that Mr. Zhang had asked how the relative equality of distribution of income in Sri Lanka was affecting the rate of savings, and whether the high level of profits remitted abroad by foreign corporations in Sri Lanka had affected the rate of domestic savings in Sri Lanka. There had been an increase in private savings since the change in policy in 1977, notwithstanding the adverse developments in the terms of trade. In fact, the policies had envisaged a relatively faster growth of incomes in such sectors as agriculture, paddy, trade, construction, and real estate. However, since those sectors were taxed at low rates, there had been some deterioration in the performance of public savings. The transfer of profits and dividends abroad had little impact on domestic savings, as it amounted to no more than SDR 10 million a year.

In conclusion, the staff representative from the Asian Department considered, future relations between Sri Lanka and the Fund would depend on a satisfactory review of the present program as well as on the success of negotiations with the World Bank for a structural adjustment loan.

The staff representative from the Exchange and Trade Relations Department, replying to Mr. Zhang's question regarding the appropriateness of including structural measures in a one-year stand-by arrangement, remarked that, as a general rule, the Fund would support policies needed to help members to solve their balance of payments problems and thereby safeguard the revolving character of the Fund's resources. At times, such a strategy called for other demand management measures; at other times, it also required other types of measures. In general, any arrangements that sought to bring the balance of payments into a viable position would involve different types of measures. He would therefore argue against making too clean a cleavage between demand management and structural policies in a stand-by arrangement. While in the abstract it would be possible to conceive two extremes, one concerned with demand management, the other with structural adjustment, most arrangements did in fact include measures that would cover both sides.

As to where Sri Lanka would come within the various categories of countries that had been discussed in the context of the enlarged access policy, the staff representative recalled that Executive Directors had decided on two broad categories, of which one would justify use of the Fund's resources close to the limit, and another that would call for lower amounts than the limit, partly because the balance of payments adjustment could not be expected to be complete within three years. Sri Lanka came within that second group of countries. It was evident that in Sri Lanka it was unlikely that the balance of payments adjustment would be completed in three years. As to how the Fund would proceed at the end of the program for 1983/84, if the member was willing and able to undertake a strong adjustment effort that gave sufficient assurance that the balance of payments adjustment could be completed within three years, it could conceivably be shifted from one category to the other.

Mr. Zhang inquired why, in the present circumstances, the Fund should not have worked out an extended arrangement with Sri Lanka in the first instance.

The staff representative from the Exchange and Trade Relations Department explained that when the Fund undertook to commit its resources for a three-year period, a member needed to have a well-defined policy program and policy commitments to cover the whole of the three years, something that did not exist in the present instance. While the Fund would not need to have a complete set of performance criteria with quantitative definitions, it would certainly need to have some idea of what the budget policy would be for the whole three-year period. It was true that the guidelines on conditionality did allow for both types of approach. When a country could establish that it was in a position to commit itself to policies over an extended period, a long-term arrangement was appropriate. When a country was not in that position, a succession of one-year arrangements was a preferable course of action.

Mr. Zhang remarked that there seemed to be little difference between the case of Romania and the case of Sri Lanka; yet the Fund was apparently prepared to grant a three-year arrangement to Romania, whether it was called a three-year stand-by arrangement or a three-year extended arrangement, compared with only one year for Sri Lanka. The policy did not appear to be very consistent.

Mr. Jayawardena noted that the effect of the recent disturbances in Sri Lanka had been as if a tornado had hit the country. Many people at all levels had been trying to understand the underlying causes. If his authorities had heard some of the observations made by Executive Directors on the future path of adjustment, they would surely think that another tornado was about to strike them. Although he had said it previously, he would repeat that it was important for Executive Directors to be aware of the difference in the impact of adjustment on high-income and on low-income countries. For instance, a 5 percent adjustment in an industrial country would probably mean a slowdown in the growth of incomes and some unemployment. In a low-income country, a similar adjustment would, in the absence of a social security net, mean not only a substantial lowering of living standards for a majority of the people, but also malnutrition and starvation for many. That was why he had said that the process of adjustment in Sri Lanka would require time and care. He had recently been reading about the tremendous pains of adjustment in countries with four or five times Sri Lanka's per capita income of $250 a year.

He would say, Mr. Jayawardena went on, that his authorities did not regard the adjustments that had been launched in 1983 as modest. They regarded them as representing the first stage in bringing back the economy to the path of adjustment. Some of the structural weaknesses that had been identified would certainly be addressed by his authorities in the future, as resolutely as they could.

Some Executive Directors, Mr. Jayawardena recalled, had expressed disappointment at Sri Lanka's returning to the Fund after completing an extended arrangement some two years previously. There had been no expectation in that extended arrangement that the imbalances that had grown up over 30 years would be rectified in three years or so. The progress made in those three years had been documented, and the results were there for all to see. The expectation at that time had been that Sri Lanka would continue to persevere on a path of adjustment for some time to come.

Regarding the details of the program, Mr. Jayawardena remarked that the revenue effort of 1983, equivalent to 2.5 percent of GDP, was by no means small. While revenue might have fallen off in the past few years, Executive Directors should remember that the situation in 1977 was such that extraordinary concessions had to be granted to a long-stifled private sector to restore business confidence. Those incentives had served their useful purpose and were being withdrawn. Directors should also be mindful of the deleterious effects on government revenue of adverse movements in the terms of trade, which had been unprecedented. Sri Lanka had started its long-overdue adjustment process at the worst possible time, in the midst of a world recession that was recognized as the worst since World War II.

His authorities were most anxious to set the public corporations on a sound footing, Mr. Jayawardena explained. Several uneconomic public enterprises had already been closed down or opened to competition from the private sector, and they had been compelled to make a return for the Treasury. The large textile industries had been transferred to the private sector. All public enterprises, except one, had been opened to competition from the private sector. Some problems were, however, intractable. For instance, the Transport Board, which was now opened to private sector competition, had to carry on uneconomic services, whereas the private sector was interested only in the profitable ones. Second, the Fertilizer Corporation was used as a vehicle for marginally subsidizing fertilizer. In a country where it was necessary to promote the wide use of chemical fertilizers, marginal subsidization was surely warranted. Indeed, many developing countries carried on subsidization of that sort. His authorities would be only too glad to reduce the role of public enterprises; they had no ideological belief that any product should be made only by the state. Their concern was that such goods should be made; it did not matter whether they were made by the state or by the private sector.

He welcomed the endorsement by the Executive Directors on the current thrust of monetary policy, Mr. Jayawardena stated. Regarding the distortions introduced by the National Savings Bank, Directors should recall that the bank had been used in 1977 as an instrument for engineering the positive real interest rate policy. His authorities were considering alternative and less costly ways of maintaining a positive real interest rate policy, and they hoped that they could diminish the distortions that had arisen.

The question about foreign currency banking units and the fear that they might turn out to be a loophole, had been effectively answered by the staff, Mr. Jayawardena considered. There was no loophole, but only a statistical problem; the amount of borrowing was subject to approval and was being kept within manageable limits. The arrangement served to maintain the domestic positive real interest rate policy.

On the question of the viability of the fiscal deficit, Mr. Jayawardena observed that, although the deficit appeared large by conventional standards, the figures were by and large the result of a high level of foreign aid. The authorities could easily stop most of the partially completed foreign-funded projects and achieve a balance on paper. But that was surely not what the Executive Directors had in mind. Excluding foreign aid absorption, the fiscal deficit was low and of manageable proportions. The same could be said of the current account deficit of the balance of payments. Some Directors had expressed doubts about its viability, but again, it by and large reflected the high level of aid absorption in the country. Most of the projects were funded by grants or on highly concessional terms, and Executive Directors surely did not have in mind that aid absorption should be scaled down merely to achieve a figure that was deemed viable without foreign funding. Like the staff, he believed that current account deficits of the contemplated size were viable. In the present circumstances, it was the debt service ratio that was important. On that point, he had nothing to add to what the staff had said. His authorities believed that, once the payments situation improved after the easing of the present fiscal bulge, the debt position would be greatly improved.

As to commercial borrowings, his authorities had been extremely cautious, Mr. Jayawardena went on. While the volume had risen in the past two or three years, it was not something that his authorities would allow to get out of hand. On the exchange rate for the rupee, he endorsed the comments made by the staff. In reaching agreement with the staff on that subject, the authorities had several achievements to their credit. First, they had largely depoliticized the exchange rate question. There was now an agreed formula by which the exchange rate could be allowed to behave autonomously. That was a positive achievement. Second, there was the undertaking implicit in the arrangement that the rate would not be permitted to get out of alignment again. That too was a positive achievement, and something that would help in the adjustment process in Sri Lanka.

Replying to the point raised by Mr. Laske that the assumption by the Government of the ownership of damaged properties after the recent disturbances might be a risky operation that placed strains on the budget, Mr. Jayawardena explained that his authorities did not like being a landlord in that situation. They had become one purely on compassionate and humanitarian grounds, because there had been tremendous pressure by people to buy the affected properties at nominal prices, and there had been several instances where tenants had been shut out of their houses, with no means of returning. The current position was that, on request by any owner, the affected properties would be returned. His authorities had no desire to be saddled with damaged properties and their reconstruction at public expense. If some assistance had to be given to help people to rebuild their properties, his authorities would certainly consider additional revenue or other measures to meet those obligations.

Finally, he did not have the impression that Executive Directors were disenchanted with Sri Lanka's rate of adjustment, Mr. Jayawardena concluded. The Directors had always had a sympathetic understanding of Sri Lanka's problems, and he hoped that that understanding would continue.

The Chairman then made the following summing up:

Executive Directors noted that under the combined impact of a deterioration in the external terms of trade, expansionary financial policies, and reduced flexibility in administered prices and the exchange rate, pressures on the balance of payments and prices had been strong in the period 1980-82, and that little progress had been made in the correction of the structural weaknesses of the economy.

Directors commended the Sri Lanka authorities for the stabilization policies initiated in 1983, but several stressed that they were only a modest step on the road toward restoring a viable internal and external financial position. The increased budget revenue effort, the containment of public capital outlays, and the greater flexibility in pricing policy should lead to an improvement in public finance, which in turn would help to meet the genuine needs of the private sector. While Directors noted the decisions of the authorities not to introduce new public investment projects in 1983 and 1984, they called for more restraint on operating outlays as well as for major revenue efforts. To stress the needed major improvement in government revenue, speakers noted the narrowness of the tax base as well as the significant decline in recent years in the ratio of government revenue to GDP. Directors welcomed the decision to modify the previous monthly indexation scheme for public sector wages and called for further action to reduce the indexation mechanisms. The expected improvement in public finance, the maintenance of the cautious credit policies, and flexibility in exchange rate management would help to reduce the current account deficit of the balance of payments from the unsustainable levels of the past three years.

Directors noted the assessment made by the authorities of the impact of the recent disturbances on economic developments. The decision of the authorities not to relax financial policies and their renewed commitment to observance of the performance criteria under the negotiated stand-by program were appropriate. The stabilization effort should provide a sound basis for implementing the needed structural adjustment policies, and Directors welcomed the specific commitments of the authorities under the stand-by program to devise structural policies in several areas. But they considered that the policy decision process was overdue; early implementation was now of the essence.

Noting that the performance of exports in the recent past had been disappointing, Directors underscored the importance of maintaining external competitiveness and welcomed the authorities' commitment to a flexible exchange rate policy. They cautioned that exchange rate policy should be closely monitored in the light of external reserves and current account developments. They also emphasized that the intended adjustment of the balance of payments in the medium term would crucially depend upon major improvements in the operations of state plantations, and a reduction of the high protection offered by the present import tariff rates that had hitherto discouraged the creation of an efficient and internationally competitive manufacturing sector.

A number of Directors stressed the importance of the announced shift in investment strategy over the medium term with emphasis on private initiative and the concentration of public investment on productive and quick-yielding projects. They also underscored the need for the proper operation and maintenance of existing assets. It was vital that the medium-term investment strategy should be accompanied by major new efforts to increase domestic savings. The maintenance of real positive interest rates would help to mobilize private savings through official channels as well as to price scarce financial resources at a realistic level. The authorities were encouraged to pursue further adjustment in the operations and policies of the National Savings Bank in order to eliminate the existing distortions in the financial system. The main effort, however, would have to fall on improving the savings performance of the public sector through the introduction of a tax system that was more elastic and more responsive to economic developments, greater expenditure discipline, and, above all, an overdue improvement in the performance of public corporations. The issue of the uneconomic public enterprises should be dealt with effectively.

The Board stressed the importance of the mid-term review of the program for assessing the progress made in the implementation of the needed policies stressed above. Directors noted with concern that the outstanding external debt level and its present and future servicing were large when assessed against the recent and prospective export performance, and would remain an important constraint to economic development policies in the years ahead. In this regard, the decision to limit foreign commercial borrowing, including short-term borrowings, under the negotiated program was appropriate.

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

The Executive Board took the following decisions:

Decision Concluding 1983 Article XIV 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.

Decision No. 7522-(83/139), adopted
September 14, 1983

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 September 14, 1983, through July 31, 1984.

2. The Fund approves the stand-by arrangement attached to EBS/83/166, Supplement 1, and waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7523-(83/139), adopted
September 14, 1983

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/138 (9/12/83) and EBM/83/139 (9/14/83).

4. RWANDA - TECHNICAL ASSISTANCE

In response to a request from Rwanda for technical assistance, the Executive Board approves the proposal set forth in EBD/83/232 (9/8/83).

Adopted September 13, 1983

5. ASSISTANT TO EXECUTIVE DIRECTOR - EXTENSION OF OVERLAP PERIOD

The Executive Board approves the recommendation set forth in EBAP/83/229 (9/9/83).

Adopted September 13, 1983

6. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/83/230 (9/12/83) is approved.

APPROVED: March 12, 1984

LEO VAN HOUTVEN
Secretary