

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR
AGENDA

EBS/90/167
Correction 1

CONFIDENTIAL

October 18, 1990

To: Members of the Executive Board

From: The Secretary

Subject: Sri Lanka - Staff Report for the 1990 Article IV
Consultation and Request for the Third Annual Arrangement
Under the Structural Adjustment Facility

The following corrections have been made in EBS/90/167 (9/24/90):

Page 6, column 8, line 2: for "106.8" read "105.7"
line 3: for "35.5" read "35.1"
line 4: for "13.9" read "12.8"

Page 18, 2nd full para., lines 7 and 8: for "credit remained...during"
read "credit rose...during"
para. 2, line 10: for "fell by 11 percent offsetting"
read "fell by 2 percent partly offsetting"

Page 23, line 1: for "maintain experience competitiveness."
read "maintain external competitiveness."

Page 68, column 1, line 1: for "25.1" read "25.7"
line 2: for "102.6" read "105.7"
line 3: for "32.1" read "35.1."

Corrected pages are attached.

Att: (4)

2. Recent developments and performance under the SAF

a. First annual arrangement

Performance during the first year of the SAF arrangement (March 1988-March 1989) was marred by low economic growth, rising inflation, and a weakening balance of payments. ^{1/} Underlying this deterioration was an overall government deficit that exceeded the program target by almost 6 percent of GDP, attributable to the worsening security conditions and to revenue shortfalls and expenditure overruns, especially on wages and salaries. The larger deficit resulted in heavy recourse to domestic bank borrowing (5 percent of GDP), a 33 percent rise in reserve money, and an accelerating loss of reserves toward the end of the year as confidence waned.

The financial imbalances persisted into 1989 as the southern insurgency intensified, unsettled conditions continued in the North, and a number of policy decisions made prior to presidential elections in late 1988 (increased welfare programs in particular) began to jeopardize the adjustment effort. The Government made continued heavy recourse to bank credit, particularly from the Central Bank, and the demand effect was accentuated by substantial bank financing of the public enterprises. With domestic confidence at a low ebb, the impact of this demand imbalance on prices was muted (inflation rates actually declined through much of 1989); instead external reserves came under severe pressure. By August 1989, gross official reserves had fallen to three weeks of import coverage, all of which was the counterpart of external short-term borrowing by the Central Bank.

b. Second annual arrangement

The authorities' eventual response, supported by the second-year SAF arrangement (October 1989-September 1990), was a pronounced tightening of fiscal and monetary policy from August 1989, accompanied by a rupee depreciation. Consequently, Sri Lanka's macroeconomic performance improved beyond expectations in most respects. All quantitative benchmarks through June 1990 were observed with a large margin (Table 2), notably those on the net domestic assets of the monetary authorities and on external reserves where the excess over the benchmark was the equivalent of four weeks of imports.

The fiscal program envisaged an overall deficit of 12.5 percent of GDP in 1989, 1.2 percent of GDP smaller than the initial budget, and

^{1/} A full review of performance under the first year of the SAF arrangement is contained in EBS/89/186 (9/20/89).

Table 2. Sri Lanka: Quantitative Benchmarks and Performance During the Second Annual Arrangement Under the Structural Adjustment Facility, 1989-90

	1989			1990				
	June	Sept.	December	March		June		Sept.
				Benchmark	Actual	Benchmark	Actual		Benchmark

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

1/ Defined to exclude the Treasury/IMF and international reserve revaluation accounts.

2/ Excludes the domestic currency counterpart of Fund accounts.

3/ Cumulative from October 1, 1989.

4/ Net official reserves defined as the sum of: (a) the Central Bank's foreign assets less liabilities with a maturity of up to one year; (b) the Treasury's foreign assets less liabilities with a maturity of up to one year; and (c) the liabilities to the IMF.

5/ Excludes use of Fund resources and normal trade financing. The definition of concessional assistance conforms to that adopted by the Development Assistance Committee (DAC).

estimated may cause a revenue loss of 1-2 percent of GDP; in 1991, the authorities plan to reduce the maximum tariff from 60 percent to 50 percent, making good only a part of the revenue loss through increased excises. The authorities expect that revenue loss from tax reform may be offset somewhat by improved tax administration: a project to improve procedures for income tax collection--initially for a small group of large taxpayers--has begun with Fund technical assistance, and a project is being planned for the computerization of the customs department. The staff stressed that, in implementing the NTC recommendations, broad revenue neutrality should be the objective, at least for 1991.

With the devolution of revenue raising powers in 1991 to the provincial councils (PCs), an additional revenue loss of less than 1 percent of GDP is anticipated. However, since the PCs are expected to assume responsibility for the corresponding amount of noninterest expenditure, no net impact on the overall deficit is likely. Because of these considerations, revenue in 1991 is projected to decline from 20 percent of GDP to 19 percent of GDP.

The program for 1991 envisages a deficit of about 9 percent of GDP, ^{1/} further reduction in the net domestic financing requirement, and sizable net repayments to the banking system. The onus of adjustment will fall on recurrent expenditure, which is expected to increase in nominal terms by only 3 percent, and to decline by 2.5 percent of GDP to about 20 percent. Capital expenditure (including net lending), on the other hand, is to remain at the 1990 level of 9 percent of GDP. The reduction in recurrent outlays will be achieved by: (a) a fall in defense expenditure to about 4 percent of GDP, 1 percentage point lower than programmed for 1990; (b) containing the increase in the wage bill within 9 percent by continuing a hiring freeze on all but essential posts, eliminating positions that have remained vacant for more than two years; and (c) limiting expenditures on the core welfare programs (food stamps, Jana Saviya, and school meals) to about 2.5 percent of GDP.

In the last few years, total central government debt in relation to GDP has risen significantly, increasing to over 100 percent of GDP in 1989. Staff estimates indicate that this trend would be reversed, partly on account of the fiscal adjustment envisaged under the SAF program. The debt ratio is projected to contract both in 1990 and 1991,

^{1/} As in the 1989-90 program, no explicit provision has been taken for the expenditure, as yet unquantified, on restructuring the CTB and a number of public manufacturing enterprises prior to privatization, and for implementing the administrative reform, mainly the cost of retrenchment packages for public servants. Correspondingly, disbursements from two major loan programs by the World Bank--the ERC including cofinancing, and a public enterprise restructuring project--have been excluded.

assuming no significant valuation impact of the exchange rate on the debt.

Realistic budgeting will be supported by revitalized expenditure controls. Some systems are already in place: a monthly reporting system on cash outlays, an increasingly active role for the Budget Review Committee, curtailment of advance accounts, and the requirement of Cabinet approval for the carryover from one year to the next of unspent appropriations. In addition, the Government has recently reconstituted the accounting service by bringing it directly under the jurisdiction of the Treasury to facilitate more direct expenditure control.

b. Monetary policy

Total liquidity growth accelerated sharply from an annual rate of 9 percent at the end of 1989 to an annual rate of 15 percent at mid-1990 with the composition shifting to the less liquid forms of interest-bearing time and savings deposits. This expansion was mainly associated with a further substantial rise in external reserves in early 1990 which was only partially sterilized through the Central Bank selling treasury bills to the nonbank sector. Domestic credit rose by about 4 percent during the first half of 1990. With the continuation of tight fiscal policies, credit to the public sector fell by 2 percent partly offsetting a rise in credit to the private sector.

The authorities concurred with the staff's view that, with inflation at over 20 percent, liquidity growth needed to be contained. Thus, the fiscal measures to contain the Government's recourse to bank borrowing are being supplemented by a tightening in monetary policy. During July, the bank rate was raised by 1 point to 15 percent; interest rates at the National Savings Bank (NSB) rose by two percentage points; and interest rates at the treasury bill auction rose by about 2 percentage points through end-August. These adjustments can be expected to precipitate a general rise in the interest rate structure. The authorities expect most key interest rates to be positive in real terms before the end of 1990, given the anticipated reduction in the rate of inflation and further upward adjustments in nominal interest rates, including those in the treasury bill auction. The authorities are also considering means of increasing the degree of market influence in determining the interest rates, and of evolving a more effective system of reserve money management (see Section III.6).

In present circumstances, the authorities believe that it would be premature to lift the direct controls introduced in May 1989--selective

to accumulate reserves and maintain external competitiveness. Transaction rates between commercial banks and customers continue to be freely determined by the banks; since rates are closely linked to the interbank rate, they do not differ significantly among bankers. The mission argued that the band within which the Central Bank's rates will fluctuate should be sufficiently wide to allow the Central Bank to move the rate flexibly and speedily whenever necessary to achieve its objectives without contributing to market speculation. As experience is gained, official intervention should diminish and be limited to the extent necessary to avoid excessive fluctuation in the market from day to day. The size of the band under the new system will be reviewed in light of the first few months' experience and may be widened in due course.

In the first two weeks of its operation, the authorities intervened to sustain the exchange rate, with some loss of official reserves, to counteract speculative trading. Recently, more orderly conditions have returned to the market, the Central Bank has been a net buyer, and the reference rate has moved to SL Rs 39.9 per U.S. dollar.

In addition to the exchange rate measure, the expansion in exports in 1990-91 is expected to be boosted by a number of recent administrative measures, including a reform of the allocation system for garment export quotas to allow their fuller utilization, a deregulation of the shipping and air cargo industries, and a simplification of export procedures. Furthermore, procedures related to foreign investment have been streamlined, and fiscal incentives have been extended to specified priority activities, in particular to export-oriented businesses aimed at new products or markets.

External borrowing, a cause of some concern in the second arrangement under the SAF, was contained well within program targets. By March 1990, the Central Bank had repaid all the short-term credit contracted in 1989. Similarly, short-term borrowing by the public enterprises, which was permitted to ease the foreign exchange shortage experienced during the first half of 1989, will be reduced considerably in 1990 and 1991. The authorities have continued their policy of neither contracting nor guaranteeing nonconcessional borrowing, except for normal trade credit, mixed project lending, or externally guaranteed financing of food imports.

Sri Lanka's exchange system is free of restrictions on payments and transfers for current international transactions, except for the restriction arising from the limitations on the availability of foreign exchange for personal travel abroad, which is maintained in accordance with the transitional arrangements under the provisions of Article XIV, Section 2, and the stamp duty on letters of credit for imports (other than food and inputs in export production) not fully covered by deposits which was increased from 2 to 3 percent in mid-1988 for budgetary reasons. This measure constitutes a multiple currency practice, subject

to Fund approval under Article VIII, Section 3. The authorities indicated that it remained difficult to reduce the duty at the present time in view of the high fiscal deficit. Since June 1989, commercial banks have been required to hold a 100 percent interest-bearing deposit against letters of credit for selected luxury imports, which does not give rise to a multiple currency practice.

4. Public sector reform

a. Public employment

The authorities' approach to reducing the size and cost of public sector employment in the long term--evolving from the recommendations in 1988 of the Administrative Reforms Committee (ARC)--has three distinct elements: reduction in the number of employees, management development and efficiency improvement, and compensation policies.

The ARC suggested that overstaffing may be as high as 80,000-90,000 out of a total of some 500,000 employees in the public service. The Government's initial target was to reduce public employment by 18,000-20,000 by the end of 1990. Since late 1989, the Government has closed or reorganized five departments, resulting in some 3,000 voluntary redundancies for which compensation was paid. It is expected that the remaining staff reduction will occur through natural attrition, notably the unusually high number of public servants currently reaching retirement age; by mid-year a reduction of about 10,000 had been realized. The mission stressed that the realization of the targeted reduction places heavy emphasis on the rigorous implementation and monitoring of the hiring freeze under which vacancies are not being filled, with the exception of a few technical positions. The authorities also intend to establish specific guidelines and a timetable for further reductions in employment over the next 3-4 years. In doing so they are also taking account of the staffing requirements of the new Provincial Councils, which in 1990 have assumed many of the functions previously performed by the central government, applying the targets for employment reduction to the combined total of the central and provincial administrations.

The authorities are beginning to formulate policies designed to promote efficiency, and to this end, the Government has created a special Policy Division in the Ministry of Public Administration. Among the tasks of this new division will be a review of public sector remuneration to determine whether professional grades remain relatively underpaid and whether certain types of remuneration remain excessive. At the same time, the authorities are determined to depoliticize personnel management and recruitment, an issue that many believe lies at the heart of the civil unrest in 1989. Public and Provincial Service Commissions are being strengthened, and some new recruitment practices have already been put in place.

33. The Government remains firmly committed to maintaining an open trade and exchange system. Over the program period, the Government will not introduce or modify multiple currency practices; nor will it introduce or intensify restrictions on payments and transfers for current international transactions; nor will it introduce restrictions on imports for balance of payments purposes, nor conclude bilateral payments agreements inconsistent with Article VIII of the Fund's Articles of Agreement. The Government will endeavor to find alternative revenue sources to the 3 percent stamp duty on letters of credit for imports not fully covered by cash deposits that gives rise to a multiple currency practice.

34. Performance under the program supported by the arrangement under the structural adjustment facility will be assessed through close monitoring of quantitative benchmarks set out in the attached Table 1, which will enable the Government of Sri Lanka to take timely remedial action when necessary. In particular, fiscal, monetary, and exchange rate policies will be strengthened when required, to meet the targets and objectives of the program. Benchmarks for monitoring policy implementation in the structural areas during the program period are shown in the attached Table 2.

Table 1. Sri Lanka: Quantitative Benchmarks for the Third Annual Arrangement
Under the Structural Adjustment Facility, October 1990-September 1991

	1990			1991		
	June 30	Sept. 30 Est.	Dec. 31 B'mark	March 31 B'mark	June 30 B'mark	Sept. 30 B'mark
(In SL Rs billion)						
Net domestic assets of the monetary authority <u>1/</u>	25.7	26.0	26.1	25.4	25.7	25.2
Credit from domestic banking system <u>2/</u>	105.7	110.2	113.8	116.6	117.4	119.2
Of which:						
Net bank credit to the central government <u>2/</u>	35.1	35.0	36.2	34.9	34.0	32.5
Bank credit to public enterprises	12.8	15.5	16.2	16.6	17.0	17.3
(In SDR millions)						
Net official reserves (floor) <u>3/</u>	-38	-54	-51	-41	-40	-17
New concessional external loans contracted or guaranteed by the nonfinancial public sector <u>4/</u>	...	...	100	100	100	100
Up to 1-year maturity	...	...	--	--	--	--
With 1- to 12-year maturities	...	...	100	100	100	100

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

1/ Defined to exclude the Treasury/IMF, the international reserve revaluation account, and the loans to IMF No. 1 account.

2/ Excludes the domestic currency counterpart of Fund accounts.

3/ Net official reserves defined as the sum of: (a) the Central Bank's foreign assets less liabilities with a maturity of up to one year; (b) the Treasury's foreign assets less liabilities with a maturity of up to one year; and (c) the liabilities to the IMF.

4/ Excludes use of Fund resources and normal trade financing. The definition of concessional assistance conforms to that adopted by the Development Assistance Committee (DAC). Cumulative beginning October 1, 1990.