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September 24, 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

Attached for consideration by the Executive Directors is the staff report for the 1990 Article IV consultation with Sri Lanka, together with its request for the third annual arrangement under the structural adjustment facility. Draft decisions appear on pages 36 and 37.

This subject, together with the policy framework paper for Sri Lanka (EBD/90/307, 9/24/90), is proposed to be brought to the agenda for discussion on Monday, October 22, 1990.

Mr. K. Saito (ext. 7450) or Mr. M. Bell (ext. 8670) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

SRI LANKA

Staff Report for the 1990 Article IV Consultation
and Request for the Third Annual Arrangement Under
the Structural Adjustment Facility

Prepared by the Asian Department

(In consultation with the Central Banking, Exchange
and Trade Relations, Fiscal Affairs, Legal, and Treasurer's
Departments, and the Bureau of Statistics)

Approved by Kunio Saito and Thomas Leddy

September 21, 1990

| | <u>Contents</u> | <u>Page</u> |
|------|---|-------------|
| I. | Introduction | 1 |
| II. | Background to the Discussions | 3 |
| | 1. Structural origins of financial imbalances | 3 |
| | 2. Recent developments and performance under the SAF | 5 |
| | a. First annual arrangement | 5 |
| | b. Second annual arrangement | 5 |
| III. | Report on Discussions and the Third Annual Arrangement (1990-91) | 9 |
| | 1. Policy objectives | 11 |
| | 2. Domestic financial policies | 13 |
| | a. Fiscal policy | 13 |
| | b. Monetary policy | 18 |
| | 3. External policies | 19 |
| | 4. Public sector reform | 24 |
| | a. Public employment | 24 |
| | b. Public expenditure | 25 |
| | 5. Industrial policy and public enterprises | 26 |
| | 6. Financial sector | 28 |
| | 7. Social impact of adjustment policies | 28 |
| | 8. Program benchmarks | 29 |

| <u>Contents (cont'd)</u> | <u>Page</u> |
|---|-------------|
| IV. Medium-Term Prospects | 29 |
| 1. Prospects for the balance of payments | 29 |
| 2. Capacity to meet financial obligations to the Fund | 32 |
| V. Staff Appraisal | 32 |

Text tables

| | |
|--|----|
| 1. Fund Position During Period of the Structural Adjustment Arrangement, 1990-91 | 2 |
| 2. Quantitative Benchmarks and Performance During the Second Annual Arrangement Under the Structural Adjustment Facility, 1989-90 | 6 |
| 3. Performance Against Structural Benchmarks of Policy Implementation During the Second SAF Arrangement, October 1989-September 1990 | 10 |
| 4. Key Macroeconomic Targets Under the Third-Year SAF Arrangement, 1988-91 | 12 |
| 5. Summary of Central Government Operations, 1987-91 | 14 |
| 6. Monetary Developments, 1985-91 | 20 |
| 7. Balance of Payments, 1985-91 | 22 |
| 8. Medium-Term Scenario, 1987-95 | 31 |

Charts

| | |
|--|-----|
| 1. Macroeconomic Performance and Targets Under the Third-Year SAF, 1985-91 | 4a |
| 2. Investment and Savings, 1980-89 | 4b |
| 3. Fiscal Developments, 1984-90 | 4c |
| 4. Exchange Rate Indices, January 1980-June 1990 | 22a |

Annexes

| | |
|---|----|
| I. Fund Relations | 38 |
| II. Relations with the World Bank Group | 42 |
| III. Relations with the Asian Development Bank | 45 |
| IV. Selected Economic and Financial Indicators, 1987-91 | 48 |
| V. Social and Demographic Indicators | 49 |
| VI. Statistical Issues | 50 |

| <u>Contents (concluded)</u> | <u>Page</u> |
|---|-------------|
| <u>Attachments</u> | |
| I. Structural Adjustment Facility: Third Annual Arrangement | 52 |
| II. Letter of Transmittal and Memorandum on Economic and Financial Policies for 1989-90 | 54 |
| Table 1. Quantitative Benchmarks for the Third Annual Arrangement Under the Structural Adjustment Facility, October 1990-September 1991 | 68 |
| Table 2. Structural Benchmarks of Policy Implementation Under the Structural Adjustment Facility, October 1990-September 1991 | 69 |

I. Introduction

A staff mission visited Colombo during the period June 25-July 10 to conduct the 1990 Article IV consultation discussions and to negotiate financial and economic program to be supported by the third annual arrangement under the structural adjustment facility (SAF). 1/ Meetings were held with President Premadasa; Mr. Wickremasinghe (Minister of Industries) and Mr. Wijeratne (Minister of Plantation Industries and Minister of State for Defense); Mr. Paskaralingam, Secretary to the Treasury; Mr. Karunatilake, Governor of the Central Bank; and other senior officials.

In the attached letter to the Managing Director, dated September 20, 1990, the Government of Sri Lanka requests the third annual arrangement under the SAF in an amount equivalent to SDR 45 million (20 percent of quota). Disbursement of this amount will leave Sri Lanka's credit from the Fund at 109 percent of quota by September 1991, the end of the third annual arrangement (Table 1). The Memorandum on Economic and Financial Policies, describing the program that the Government intends to implement during 1990-91, is attached to the letter. The policy framework paper (PFP) for the period 1990-93, which updates and extends the second PFP (EBD/89/285, 9/15/89), has been distributed separately as EBD/90/307, 9/24/90. It is expected that the PFP will be considered by the Executive Directors of the World Bank, meeting as a Committee of the Whole, in early October 1990, and that it will be distributed by the World Bank at an Aid Group meeting scheduled for October 25, 1990. The Executive Board approved a three-year arrangement under the structural adjustment facility (SAF) and the first annual arrangement thereunder on March 9, 1988, and the second annual arrangement on October 11, 1989. Disbursements under the first and second annual arrangements amounted to SDR 112 million (50 percent of quota).

The proposed third annual arrangement under the SAF is presented in Attachment I, and the letter of transmittal from the Government of Sri Lanka and the Memorandum on Economic and Financial Policies comprise Attachment II. Summaries of Sri Lanka's relations with the Fund, the World Bank Group, and the Asian Development Bank (AsDB) are presented in

1/ The mission comprised Mr. K. Saito (Head), Mr. Schulz, Ms. Gulde (all ASD), Ms. Meesook (ETR), Mr. S. Gupta (FAD), and Ms. Job, (Administrative Assistant, ASD). The mission was assisted by Mr. M. Bell, the Resident Representative, and by Mr. Snoek, his successor. Mr. Zagha (World Bank) and Mr. Aggarwal (the World Bank Resident Representative) participated in discussions on the Policy Framework Paper (PFP). Mr. L.E.N. Fernando, Alternate Executive Director for Sri Lanka, also participated in the meetings as an observer.

Table 1. Sri Lanka: Fund Position During Period of the
Structural Adjustment Arrangement, 1990-91

| | Outstanding June 30, 1990 | 1990 | | 1991 | | |
|--|---------------------------------|----------------|---------------|----------------|----------------|----------------|
| | | June- Sept. | Oct.- Dec. | Jan.- March | April- June | July- Sept. |
| (In millions of SDRs) | | | | | | |
| Transactions under tranche policies and EFF (net) | -- | -4.4 | -10.2 | -4.0 | -9.4 | -3.1 |
| Purchases | -- | -- | -- | -- | -- | -- |
| Repurchases | -- | -4.4 | -10.2 | -4.0 | -9.4 | -3.1 |
| Transactions under special facilities (net) | -- | -- | -- | -- | -13.6 | -13.6 |
| Purchases | -- | -- | -- | -- | -- | -- |
| Repurchases | -- | -- | -- | -- | -13.6 | -13.6 |
| Structural adjustment facility loans | -- | -- | 44.6 | -- | -- | -- |
| Total Fund credit outstanding (end of period) | 257.7 | 253.3 | 287.7 | 283.7 | 260.7 | 244.0 |
| Under tranche policies and EFF | 37.4 | 33.0 | 22.8 | 18.8 | 9.4 | 6.3 |
| Under special facilities 1/ | 108.8 | 108.8 | 108.8 | 108.8 | 95.2 | 81.6 |
| Under structural adjustment facility | 111.5 | 111.5 | 156.1 | 156.1 | 156.1 | 156.1 |
| (In percent of quota; end of period) | | | | | | |
| Total Fund credit outstanding | 115.5 | 113.6 | 129.0 | 127.2 | 116.9 | 109.4 |
| Under tranche policies and EFF | 16.8 | 14.8 | 10.2 | 8.4 | 4.2 | 2.8 |
| Under special facilities | 48.8 | 48.8 | 48.8 | 48.8 | 42.7 | 36.6 |
| Under structural adjustment facility | 50.0 | 50.0 | 70.0 | 70.0 | 70.0 | 70.0 |
| Memorandum item: | | | | | | |
| Trust Fund loans outstanding | | | | | | |
| In millions of SDRs | 0.8 | 0.4 | 0.4 | -- | -- | -- |
| As percent of quota | 0.4 | 0.2 | 0.2 | -- | -- | -- |

Source: IMF, Treasurer's Department.

1/ Compensatory financing facility.

Annexes I, II, and III, respectively. The proposed decisions appear on pages 36 and 37. Sri Lanka is on the standard 12-month consultation cycle, and continues to avail itself of the transitional arrangements under the provisions of Article XIV.

In concluding the 1989 Article IV consultation with Sri Lanka on October 11, 1989 (EBS/89/186, 9/20/89), Executive Directors welcomed the resumption of economic and structural adjustment under the second-year SAF program. They stressed the importance of fiscal policy, notably the need to reduce current expenditures, including the wage bill and transfers to households and corporations. Directors also emphasized the importance of a restrained monetary policy using market-oriented instruments, rather than controls, and called for exchange rate monitoring based on balance of payments developments and international competitiveness. They also urged continued structural reform, referring especially to the civil service, restructuring and privatization of public enterprises and state plantations, broadening the tax base, and financial sector reform.

II. Background to the Discussions

1. Structural origins of financial imbalances

Sri Lanka's economic restructuring efforts originated with far-reaching trade liberalization initiated in the late 1970s, which provided a powerful stimulus to economic activities in the private sector. However, after a strong initial response, Sri Lanka has been unable to capitalize on this new orientation for four broad reasons: (a) the failure to broaden the reforms into the public sector; (b) the country's continued vulnerability to exogenous shocks (including adverse terms of trade and weather); (c) the pursuit of relatively lax financial policies for extended periods; and (d) the persistence of civil conflict.

Sri Lanka retains many of the structural impediments with which it entered the 1980s, many traceable to the size, inefficiency, and pervasive influence of the public sector. The central government employs almost 10 percent of the labor force and maintains a high level of expenditure--about 30-35 percent of GDP in recent years (Chart 1)--a consequence of several characteristics: high subsidies and transfers to households and corporations; a large and costly public administration; and a public investment program that expanded to very high levels in the early 1980s (Chart 2), partly in response to the large inflows of foreign assistance that followed the opening of the economy in 1977. A further challenge to the conduct of sound financial policies has come from the increasing importance of the new provincial councils in the past two years.

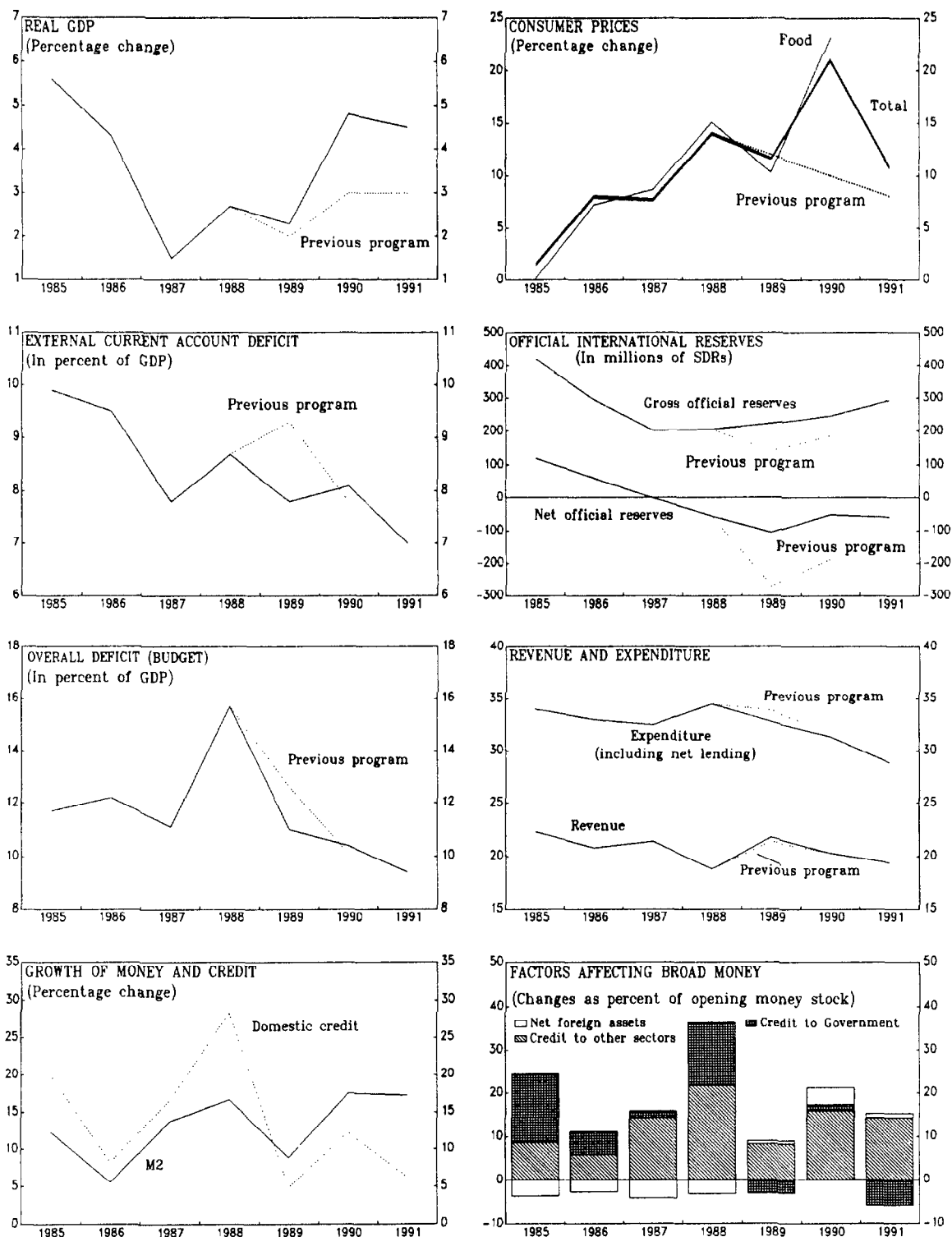
Liberalization has largely bypassed the public enterprise sector, which remains large and inefficient: there are some 130 corporations employing 600,000 people (about 10 percent of the labor force), and in recent years the manufacturing output of this sector has stagnated or declined. Attempts to improve the financial performance of a few of these enterprises met with some success, but the imbalance within the sector lingers. A significant part of the problem lies with the three large state-owned plantation corporations (tea, rubber, and coconut) which have incurred heavy losses and have generally produced at a much higher unit cost than the smaller estates in the private sector.

The pervasive influence of the public sector is reflected in the array of regulations and bureaucratic hurdles faced by potential investors or exporters. Over the years, many efforts have been made to remove these distortions: import restrictions and protective tariffs have been reduced; investment regulations have been diminished; some steps have been taken to liberalize financial and insurance markets; and, most recently, ocean freight was liberalized. Nevertheless, many minor distortions or regulations remain, perhaps individually inconspicuous, but in total amounting to a significant hindrance to private sector activity.

One consequence of the market forces released by the liberalization was that the economy became more vulnerable to inflation and/or external reserve pressures in the absence of sound macroeconomic policies. In the event, the 1980s were characterized by large external current account deficits, associated with sizable fiscal deficits (Chart 3), a major part of which was attributable to an upsurge in public investment and associated with a monetary policy that was generally accommodative. Although the fiscal and external current account deficits have declined in more recent times, there has not been a commensurate improvement in the overall balance since capital inflows have diminished, creating greater pressure on the external reserves and domestic financing of the budget.

These developments were aggravated by several waves of civil conflict, which at times became the dominant influence over economic activities. In recent years, the optimism fostered by the mid-1987 Accord with India was soon extinguished by a growing southern insurgency that was defused only toward the end of 1989. A simultaneous tightening of financial policies during the second annual arrangement under the SAF allowed a resurgence of economic activity, but these fragile stabilization gains are now being threatened by the renewed combat in the North since June 1990 between Tamil separatists and the security forces. A further threat to economic stability has arisen in recent weeks from developments in the Middle East, which have not only raised oil import costs, but may also weaken tea exports, reduce transfer payments from migrant workers, and impose costs in repatriating returning nationals.

SRI LANKA
MACROECONOMIC PERFORMANCE AND TARGETS UNDER
THE THIRD YEAR SAF, 1985-91 1/ 2/



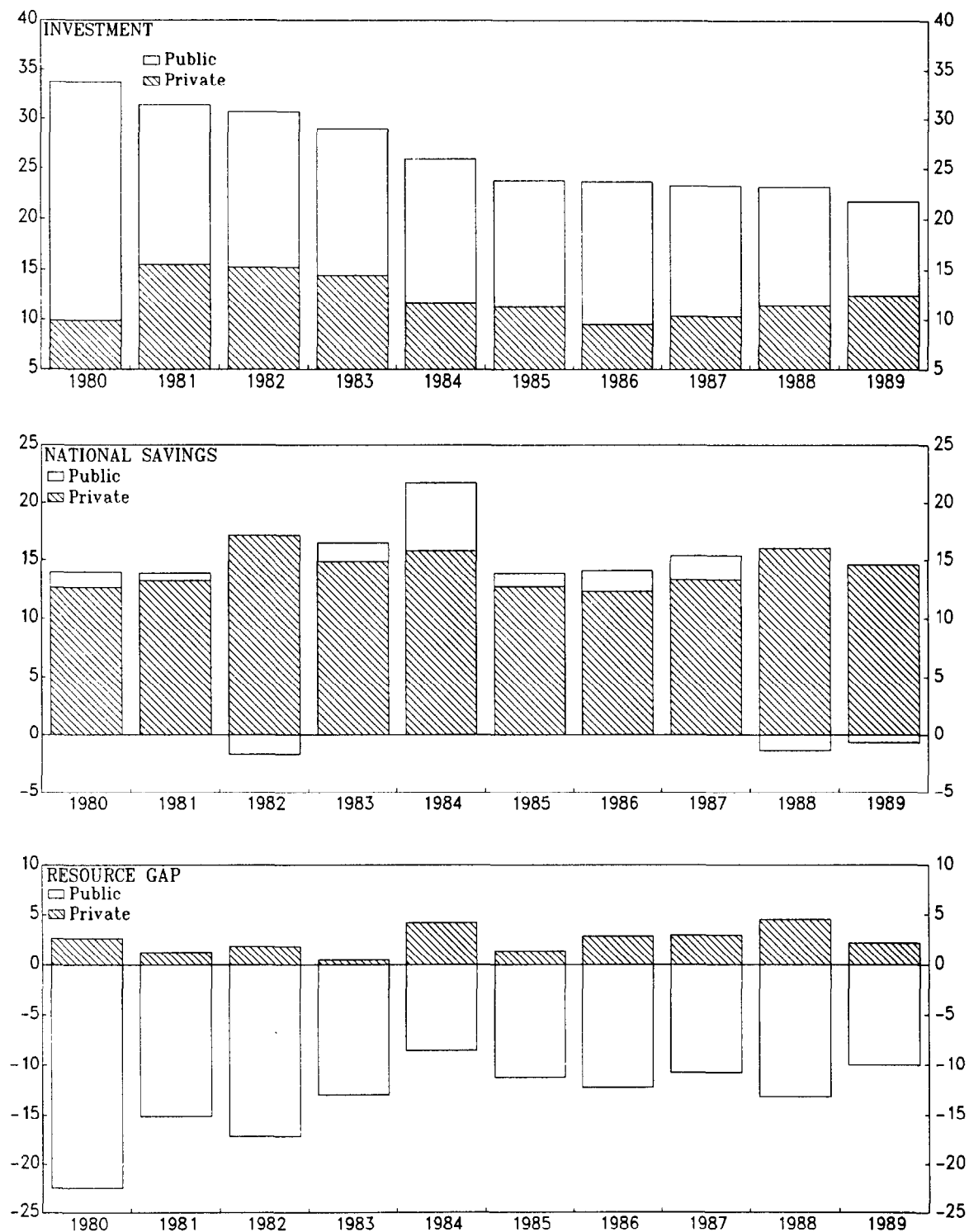
Sources: Data provided by the Sri Lanka authorities; and staff estimates and projections.

1/ Actual data through 1989.

2/ References to previous program reflect targets under the second annual SAF arrangement.

CHART 2

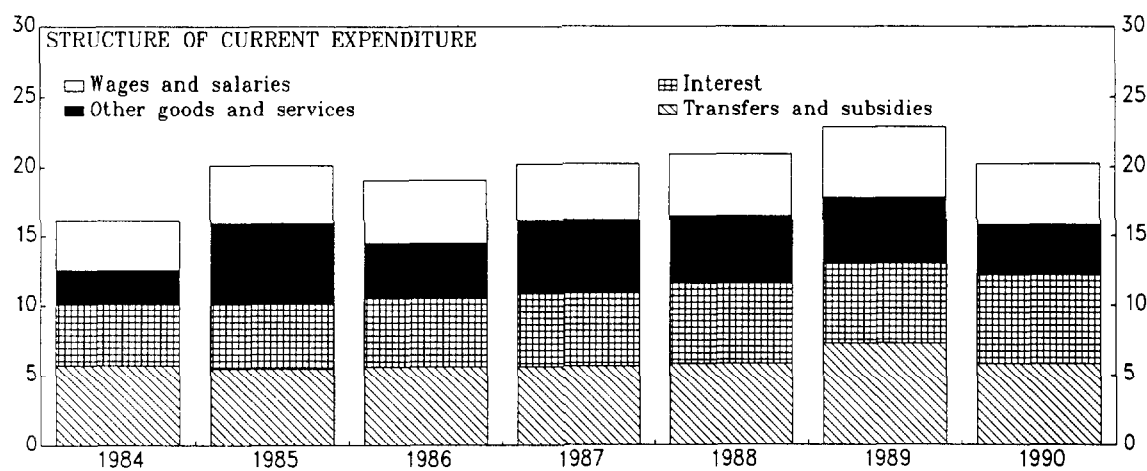
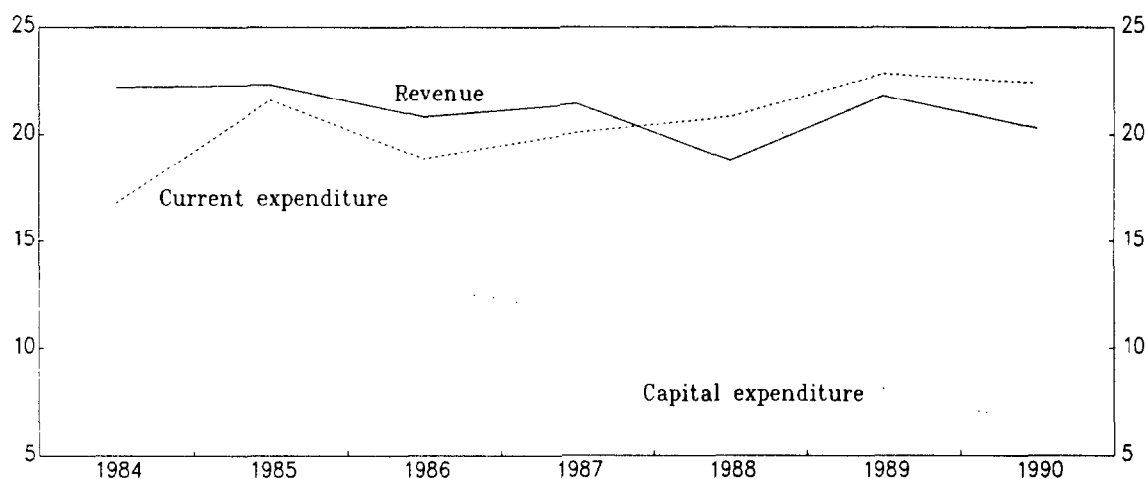
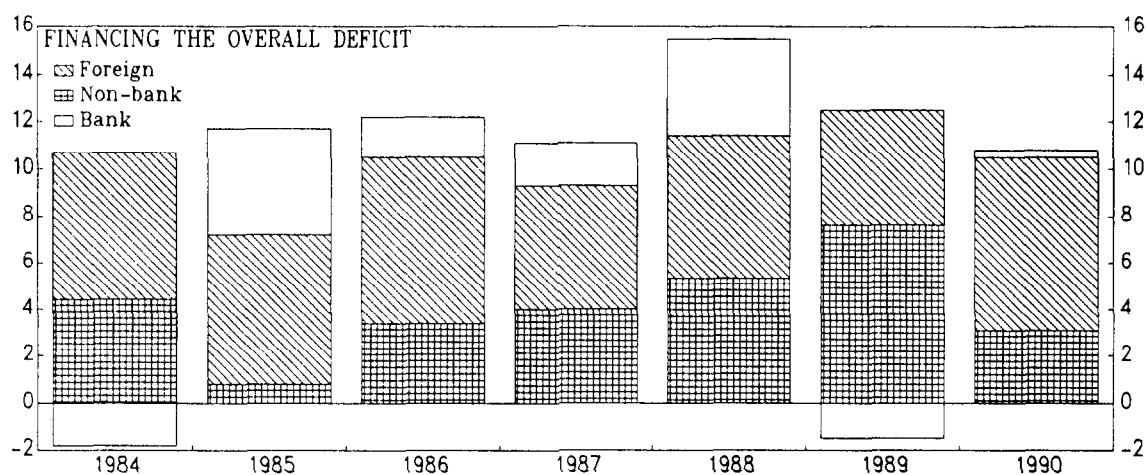
SRI LANKA
INVESTMENT AND SAVINGS, 1980-89
(In percent of GNP)



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

CHART 3

SRI LANKA
FISCAL DEVELOPMENTS, 1984-90
(In percent of GNP)



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

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 | | | Sept. Benchmark |
|---|-------|-----------|--------|-------|-----------|--------|--------------------|
| | June | December | | March | June | | |
| | | Benchmark | Actual | | Benchmark | Actual | |
| (In billions of Sri Lanka rupees) | | | | | | | |
| Net domestic assets of the monetary authorities 1/ | 31.3 | 32.0 | 35.1 | 29.8 | 34.6 | 26.9 | 34.0 |
| Credit from the banking system 2/ | 101.0 | 102.3 | 108.3 | 101.3 | 110.0 | 103.8 | 116.0 |
| Net bank credit to Government 2/ | 37.2 | 38.6 | 39.9 | 35.2 | 39.5 | 35.5 | 40.9 |
| Bank credit to public enterprises | 13.5 | 12.1 | 15.3 | 13.9 | 15.5 | 12.8 | 16.1 |
| (In millions of SDRs) | | | | | | | |
| Net official reserves: maximum loss or minimum improvement 3/, 4/ | ... | ... | -19.0 | 72.0 | -4.0 | 154.3 | 32.0 |
| New concessional external loans contracted or guaranteed by the nonfinancial public sector 3/, 5/ | ... | ... | 35.0 | 35.0 | 135.0 | 35.0 | 135.0 |
| Up to 1-year maturity | ... | ... | ... | ... | ... | ... | ... |
| With 1- to 12-year maturities | ... | ... | 35.0 | 35.0 | 135.0 | 35.0 | 135.0 |

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

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

2/ Excludes the domestic currency counterpart of Fund accounts.

33/ 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).

substantially smaller than would have occurred had no corrective policies been initiated. A further decline, to 10.4 percent of GDP, was anticipated for 1990. Pursuing these targets the authorities: (a) phased out subsidies on fertilizer, rice (both by January 1990), and flour (June 1990) and adjusted petroleum prices (December 1989); (b) deferred and rephased the Jana Saviya program (JSP, for poverty alleviation), so as to contain welfare expenditure within 3.5 percent of GDP; and (c) imposed sharp across-the-board reductions in nonwage noninterest expenditures. When it appeared that there might again be security-related revenue shortfalls, the expenditure controls were tightened further to ensure that fiscal and monetary targets were observed. In the event, revenue improved, so that the actual deficit for 1989 was only 11.0 percent of GDP, 1.5 percentage points below the target, and almost 5 percent of GDP less than in 1988. Instead of borrowing 1.6 percent of GDP from the banking system, the Government made repayments amounting to 1.4 percent of GDP.

Monetary policy supported the tightening of fiscal policy. During September 1989, three-month treasury bill rates rose from 15.7 percent to 19.3 percent, and most bank lending and deposit rates rose by 1-2 percentage points. This helped the Central Bank to sell a substantial proportion of its own holding of treasury bills and thereby to reduce its net credit to Government (by 10 percent between August and December 1989) and to sterilize almost completely the impact of the unexpectedly strong improvement in external reserves through the end of 1989. Consequently, the expansion of domestic credit in 1989 was contained to 5 percent (compared with a 28 percent increase in 1988) and that of total liquidity to 10 percent (17 percent). In early 1990, however, the stance of monetary policy was modified to accommodate the emerging economic recovery, particularly in the private sector. Interest rates on treasury bills were allowed to fall by about 3 percentage points and, while net claims on Government continued to fall, the growth of credit to the private sector picked up. These developments, together with the continued strength in the external sector, allowed domestic credit growth to be held to a year-on-year increase of 2 percent while total liquidity accelerated to 16 percent.

The external position responded very strongly to improved security and stronger financial management. After the completion of the devaluation in mid-September 1989, there was an immediate and striking improvement in the foreign reserves which continued into 1990. The initial impetus may well have come from a reversal of short-term capital outflows, but the improvement was also discernible in the current account resulting from stronger exports, lower imports, and improved services receipts, especially tourism. The current account, at 8 percent of GDP, was 2 1/2 percentage points smaller than programmed, and about 1 percent less than 1988. The overall balance for 1989 as a whole remained in deficit though substantially smaller than the program target. Gross external reserves rose to the equivalent of about 1.5 months of imports by the end of 1989, and remained close to that level

through mid-1990, despite heavy debt service payments due during the first half of the year.

Output response was also positive, with strong economic recovery taking place in most parts of the country. While the growth of real GDP in 1989 was only slightly above the 2 percent target, the growth in 1990 is now projected to be 5 percent, considerably higher than the 3 percent envisaged earlier. In contrast, price performance was disappointing. Having briefly been in the single-digit range in early 1989, the rate of inflation (measured as the point-to-point change over the previous 12 months) rose steadily to reach 15 percent in December 1989, 3 percentage points higher than the program target. Inflation accelerated further, peaking at 24 percent in July 1990 before falling back to 20 percent in August.

One specific factor, perhaps the most important, accounting for the recent rise in inflation is the impact of devaluation and subsidy removal, which were implemented beginning late summer 1989. While many of the policy actions are well past, their impact is more widespread and the lags involved are considerably longer than previously anticipated. A case in point may be the price of firewood, which was raised in mid-1990 following increases in the price of kerosene (December 1989) and electricity (April 1990); another example is that fertilizer price increases (September and December 1989) may not be reflected in food prices for up to one year. There were also sporadic shortages, particularly of food, during the past 12 months: a poor rice harvest in 1989 and occasional difficulties (often security related) in getting supplies to the cities have contributed to price increases. 1/

Two other factors seem to have contributed to a situation in which rising inflation coexisted with a relatively strong external position--a sharp contrast to the early months of 1989. First, the stronger economy and greater public confidence created conditions that were conducive not only to net capital inflows and increased business activity, but also to larger and more frequent price increases. Second, the source of monetary expansion changed: for much of 1989, domestic credit expansion was high, allowing imports to be maintained and accommodating capital flight. Although in late 1989, the improvement in external reserves was sterilized by tight monetary policy, a gradual relaxation in early 1990 may have satisfied the demand for money balances as well as accommodating persistent price increases as individuals divested short-term financial assets.

Although the focus of attention in the second SAF arrangement was economic stabilization, efforts to restructure certain features of the

1/ Food has a very high weight in the consumer price index (CPI), so that rice prices, for instance, exert a strong influence on the overall value of the index.

economy were also revitalized. Progress was made under each structural benchmark, although in some cases slippage occurred (Table 3). Structural reform concentrated on public sector issues--restructuring the public administration, and the public enterprises, where the momentum toward privatization was gathering pace. The business environment was eased by two significant moves: the complete liberalization of ocean freight and the suspension of a 100 percent tax on transfers of equity between Sri Lankans and foreigners up to a limit of 40 percent foreign ownership. ^{1/} However, further trade liberalization through the introduction of a four-band tariff now seems likely to be delayed by at least one year, owing to the complexity of redesigning the tariff structure so as to prevent excessive revenue loss.

III. Report on the Discussions and the Third Annual Arrangement (1990-91)

The rigorous implementation of stabilization policies resulted in a sharp improvement in the external position and strong economic recovery during the 1989-90 (second SAF) program, although inflation continued at a high pace. While stressing the need for sustaining the momentum of economic recovery, the authorities were concerned about the continuing inflation and the implications that this had for their efforts to alleviate poverty, as well as to restore orderly civil conditions. They were always mindful of the southern insurrection through 1989, fueled as it was by frustrated economic expectations, and were concerned lest declining living standards should reignite this particular conflict. This factor was especially prominent as the discussions were held in the context of renewed combat in the northern parts of the country between Tamil separatists and the government forces, a development that threatened to undermine the impressive stabilization gains that had been made in the preceding months.

In the weeks since the discussions were held in Colombo, events in the Middle East have necessitated the adoption of a number of additional measures (adjustments in domestic petroleum and related prices, government expenditure restraints, and monetary policy) as well as a review of the macroeconomic targets and objectives of the third-year program. The external position has been threatened not only by higher oil prices, but by lower tea exports, and the threat to private transfers from the large number of migrant workers in the affected area (Iraq and Kuwait account for some 15-20 percent of Sri Lanka tea exports and private transfers).

^{1/} The perceived significance of this policy move is reflected in the surge in equity prices on the Colombo securities exchange since the beginning of 1990. July 1990 equity prices were about 140 percent above the trough reached in mid-1989. Despite the renewal of political uncertainties, a number of foreign equity funds are commencing activities.

Table 3. Sri Lanka: Performance Against Structural Benchmarks of Policy Implementation During the Second SAF Arrangement, October 1989-September 1990

| <u>Central Government Revenues and Tax Administration</u> | <u>Timing</u> | <u>Status of Implementation</u> |
|--|---|--|
| a. Introduction of excise taxes on additional products | October 1989 | Excise Law enacted in 1989. Not yet effective owing to legal complications. |
| b. Adoption of further revenue measures in 1990 budget (paragraph 8 of memorandum) | November 1989 | Revenue measures with equivalent yield were adopted. |
| <u>Central Government Expenditure</u> | | |
| a. Hiring freeze. | Now through 1990 | In effect. |
| b. Closure of five government departments. | December 1989 | Four departments closed; one substantially reduced; by January 1990, 2,800 staff laid off. |
| c. Preparation of action plan for public sector retrenchment, with specific timetable. | December 1989 | So far 46,000 staff (10% of civil service) identified as redundant. |
| d. Implementation of action plan for 1990 public sector retrenchment. | During 1990 | 15-20,000 reduction planned in 1990 through natural attrition and voluntary redundancy. Includes staff reduction at b. |
| e. Elimination of fertilizer subsidies. | December 1989 | Implemented. |
| f. Elimination of wheat and rice subsidies. | March 1990 and during 1990, respectively. | Rice - implemented (end March 1990) Wheat - implemented (end May 1990) |
| <u>Public Enterprise Reform</u> | | |
| a. Conversion of 16 public manufacturing corporations into public companies. | October 1989 | Implemented by mid-1990. |
| b. Privatization of Thulhiriya Textile Mill and Buhari Hotel. | October 1989 | Textile mill privatized in 1989; Buhari Hotel to be completed by end-1990. |
| c. Privatization of Ceylon Oxygen and Distilleries. | December 1989 | Ceylon Oxygen flotation took place in second half 1990. Distilleries pending. |
| d. Privatization of Central Transport Board (CTB) | June 1990 | Retrenchment of 10,000 completed by June 1990; thereafter bus company will be dismantled into about 50 independent viable transport ventures. |
| <u>Trade Liberalization</u> | | |
| a. Introduction of four-band tariff with maximum rate of 50 percent. | During 1990 | Reduction of maximum to 50%; anticipated in 1991 budget (November 1990). Introduction of four-band system planned for 1992 budget (November 1991). |

Sources: EBS/89/186; and information provided by the Sri Lanka authorities.

Although the reserve accumulation now anticipated is slower than would have been the case had these adverse developments not occurred, the adjustment path remains viable, and indeed is generally somewhat stronger than had been anticipated under the second annual SAF arrangement. However, should the deterioration in the global economic environment be greater or more persistent than currently envisaged, the authorities recognize that Sri Lanka would have to take quick remedial action; they also stress that, as one of the countries most vulnerable to the effects of events in the Middle East, they stand in need of significant international assistance.

1. Policy objectives

The authorities are now intent upon consolidating the gains made in the second SAF arrangement, so as to permit a more rapid, yet sustainable, rate of economic growth than had been thought possible a year ago. They also recognize that the opportunity has been created to press ahead with major reforms. The structural measures, initiated in the second SAF arrangement and enhanced in the third, consist of three broad components: streamlining the public sector; improving the climate for trade and industry; and strengthening the financial sector, including an important modification to the exchange system.

Key macroeconomic objectives of the third SAF arrangement (Table 4)--notably growth and external viability--generally remain stronger than under the second arrangement, except in respect of inflation, which poses the most immediate policy challenge. At the heart of the adjustment effort is, therefore, a progressive reduction in the rate of inflation from 23 percent in mid-1990 to 16 1/2 percent by end-1990 and to 10 percent by end-1991. Growth in 1990 is expected to be almost 5 percent, sustained by strong agricultural output and a rebound in industrial production. A decline to 4.5 percent in 1991 seems probable given the weaker external environment now expected. The external current account deficit is expected to remain at about 8 percent of GDP in 1990, and then to fall to 7 percent in 1991, permitting a gradual increase in official reserves to about seven weeks of import coverage. To achieve these macroeconomic objectives, a tightening of fiscal policy will enable the Government to reduce sharply its use of domestic financing in 1990, with substantial repayments to the banking system in 1991. Total domestic credit growth will be held to 13 percent in 1990 and 7 percent in 1991, and the expansion of liquidity will be held well below the rate of increase in nominal GDP in both years.

The authorities remain reasonably confident about successfully pursuing their twin short-term goals--lowering inflation while maintaining the momentum of economic recovery. There is scope for better utilizing existing capacity as long as there is no further deterioration in the security situation. They also observed that the

Table 4. Sri Lanka: Key Macroeconomic Targets Under
the Third-Year SAF Arrangement, 1988-91

| | 1988 | 1989 | | 1990 | | 1991 |
|---|--------|-----------------|--------|-----------------|------------------|-------|
| | Actual | SAF Prog. 1/ | Actual | SAF Prog. 1/ | Revised Prog. | Prog. |
| (Annual percentage change; end of period) | | | | | | |
| Real GDP | 2.7 | 2.0 | 2.3 | 3.0 | 4.8 | 4.5 |
| Consumer prices 2/ | 15.0 | 12.0 | 15.1 | 10.0 | 16.5 | 10.0 |
| Total liquidity | 16.7 | 8.9 | 9.5 | 13.7 | 15.3 | 14.5 |
| Domestic credit | 28.4 | 12.0 | 4.9 | 9.2 | 12.3 | 6.3 |
| Public | 36.4 | 18.2 | 5.0 | 4.6 | 8.8 | -6.5 |
| Private | 21.8 | 6.3 | 4.7 | 13.9 | 17.5 | 17.2 |
| (In percent of GDP) | | | | | | |
| Overall budget deficit | -15.6 | -12.5 | -11.0 | -10.1 | -10.1 | -9.3 |
| Government bank borrowing | 4.1 | 1.6 | -1.5 | 0.4 | 0.5 | -1.3 |
| External current account deficit | -8.7 | -10.3 | -7.8 | -9.3 | -8.1 | -7.0 |
| (In months of imports) | | | | | | |
| Gross official reserves | 1.5 | 0.9 | 1.5 | 1.2 | 1.5 | 1.7 |

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

1/ As envisaged in the second-year SAF arrangement (EBS/89/186, 9/20/89).

2/ End of period, 12-month point-to-point basis.

largest of the price adjustments appears to have been completed and cost pressures on prices will abate. While broadly concurring, the staff noted the risk of continuing high inflation--especially if wages and salaries were to be raised or if financial policies were modified prematurely. The staff, therefore, argued that there is no room for slippage in implementing the financial policies discussed in the following Sections 2-4. Rigorous implementation of reforms--discussed in Section 5--is equally important in raising the economy's capacity for growth. These observations have become all the more germane in light of the substantially less favorable external environment that now exists.

2. Domestic financial policies

Since the onset of the crisis in the Middle East, the authorities have modified their policy stance in a number of areas. The immediate reaction was a 25 percent increase in the domestic price of most petroleum products, with an assertion that further international price increases should be passed through to the consumer so as to assure that the petroleum corporation should incur no losses. ^{1/} Bus and train fares have been increased by 40 percent, a significant part of which is attributable to fuel costs. Although the rate of inflation declined in August, the authorities are allowing the interest rate on treasury bills to rise beyond the two percentage point increase during July-August to preserve the target of realizing positive real interest rates before the end of 1990. On the budgetary side, the authorities plan to take compensating measures to offset any deterioration that occurs. Thus, although it is expected that higher expenditure and lower tea revenues will be offset by higher import duties on crude petroleum, ^{2/} the Government is imposing cash limits on departmental fuel costs designed to achieve a 25 percent reduction in consumption.

a. Fiscal policy

The program aims at limiting the overall deficit, before grants, in 1990 to 10.4 percent of GDP, ^{3/} and to reduce domestic financing from 6 percent of GDP in 1989 to 3.5 percent in 1990, thereby containing bank financing to a modest level (Table 5). In 1991, the overall deficit is projected to be 9.3 percent of GDP, implying a further reduction of

^{1/} The initial price increase in August 1990 was in response to a shipment of petroleum at a price of \$21 per barrel; thus, a further increase seems likely in the weeks ahead given recent price increases.

^{2/} The net revenue effect of higher oil prices and lower tea prices is expected to be about SL Rs 1 billion in 1991, equivalent to about 8 percent of nonwage noninterest expenditure, an amount that is believed adequate to cover higher government expenditure resulting from higher oil prices.

^{3/} This target excludes certain restructuring expenditure on the Central Transport Board (CTB) financed from external sources, amounting to 1/2 percent of GDP in 1990.

Table 5. Sri Lanka: Summary of Central Government Operations, 1987-91

| | 1987 | 1988 | 1989 | | 1990 | | 1991 1/ | |
|---|-------|-------|-------|-------|-------------------|--------|----------|--------|
| | | | Prog. | Prov. | Original Prog. | Budget | Prov. | 1/ |
| (In billions of Sri Lanka rupees) | | | | | | | | |
| Total revenue | 42.1 | 41.7 | 53.2 | 55.0 | 60.7 | 61.3 | 64.6 | 72.0 |
| Tax | 35.1 | 35.9 | 45.4 | 47.4 | 54.7 | 55.9 | 59.7 | 66.7 |
| Nontax | 7.0 | 5.8 | 7.8 | 7.6 | 6.0 | 5.3 | 5.9 | 5.3 |
| Total expenditure and net lending | 63.9 | 76.5 | 84.4 | 82.8 | 90.1 | 89.9 | 99.2 | 106.7 |
| Current | 39.6 | 46.1 | 57.8 | 57.6 | 62.4 | 63.6 | 71.0 | 73.1 |
| Of which: wages and salaries | 8.0 | 10.0 | 13.3 | 13.3 | 14.7 | 14.1 | 15.4 | 16.8 |
| Capital | 22.8 | 22.9 | 19.6 | 20.5 | 23.4 | 21.7 | 20.6 | 33.6 |
| Of which: reconstruction | — | 1.6 | 2.9 | 2.9 | 3.8 | 1.7 | 0.4 | ... |
| Net lending | 1.5 | 7.5 | 7.0 | 4.7 | 4.3 | 4.6 | 7.6 | ... |
| Of which: on-lending | 2.7 | ... | 6.6 | ... | 2.9 | ... | ... | ... |
| Overall deficit | | | | | | | | |
| Before grants | -21.7 | -34.8 | -31.3 | -27.8 | -29.5 | -28.6 | -34.5 | -34.7 |
| After grants | -17.1 | -28.1 | -24.3 | -21.4 | -21.5 | -21.8 | -28.3 | -26.0 |
| Foreign borrowing | 5.7 | 7.1 | 8.3 | 5.9 | 9.9 | 10.6 | 17.3 | 17.7 |
| Disbursements | 10.4 | 12.3 | 14.2 | 11.7 | 15.6 | 15.0 | 21.7 | 23.7 |
| Amortization | -4.7 | -5.2 | -5.9 | -5.8 | -5.7 | -4.4 | -4.4 | -6.1 |
| Domestic borrowing | 11.4 | 21.0 | 16.0 | 15.5 | 11.6 | 11.2 | 11.0 | 8.3 |
| Bank | 3.5 | 9.1 | 4.0 | -3.8 | 1.0 | 1.0 | 1.0 | -4.5 |
| Nonbank | 7.8 | 12.0 | 12.0 | 19.3 | 10.6 | 10.2 | 10.0 | 12.8 |
| Of which: identified commitments carried forward | ... | ... | — | 3.5 | ... | — | -3.5 | — |
| (In percent of GDP) | | | | | | | | |
| Total revenue | 21.5 | 18.7 | 21.3 | 21.8 | 21.4 | 21.6 | 20.3 | 19.4 |
| Tax | 17.9 | 16.1 | 18.1 | 18.8 | 19.3 | 19.7 | 17.9 | 18.6 |
| Nontax | 3.6 | 2.6 | 3.4 | 3.0 | 2.1 | 1.9 | 1.9 | 1.4 |
| Total expenditure and net lending | 32.5 | 34.3 | 33.8 | 32.8 | 31.8 | 31.7 | 31.3 | 28.8 |
| Current | 20.1 | 20.7 | 23.1 | 22.8 | 22.0 | 22.4 | 22.4 | 19.7 |
| Of which: wages and salaries | 4.1 | 4.5 | 5.3 | 5.1 | 5.2 | 5.0 | 4.9 | 4.5 |
| Capital | 11.6 | 10.2 | 7.8 | 8.1 | 8.3 | 7.6 | 6.5 | 9.1 2/ |
| Of which: reconstruction | — | 0.7 | 0.9 | 0.9 | 1.3 | 0.6 | 0.1 | ... |
| Net lending | 0.8 | 3.4 | 2.8 | 1.9 | 1.5 | 1.6 | 2.4 | ... |
| Overall deficit | | | | | | | | |
| Before grants | -11.1 | -15.6 | -12.5 | -11.0 | -10.4 | -10.1 | -10.5 3/ | -9.4 |
| After grants | -8.7 | -12.6 | -9.7 | -8.5 | -7.6 | -7.7 | -8.9 | -7.0 |
| Foreign borrowing | 2.9 | 3.2 | 3.3 | 2.3 | 3.5 | 3.9 | 5.4 | 4.8 |
| Disbursements | 5.3 | 5.5 | 5.7 | 4.6 | 5.5 | 5.3 | 6.8 | 6.4 |
| Amortization | -2.4 | -2.3 | -2.4 | -2.3 | -2.0 | -1.6 | -1.4 | -1.6 |
| Domestic borrowing | 5.8 | 9.4 | 6.4 | 6.1 | 4.1 | 4.0 | 3.5 | 2.7 |
| Of which: bank | 1.8 | 4.1 | 1.6 | -1.5 | 0.4 | 0.4 | 0.3 | -1.7 |
| Memorandum items: | | | | | | | | |
| Expenditures on defense and public order | 4.8 | 4.5 | 3.6 | 3.3 | ... | 3.4 | 4.4 | ... |
| Consolidated deficit, monitored public sector 4/ | -10.2 | -14.9 | -10.7 | 6.5 | ... | ... | ... | ... |
| Primary deficit before grants | -5.9 | -10.0 | -6.8 | -5.3 | ... | -3.1 | -4.3 | -3.1 |

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

1/ Based on detailed estimates prepared prior to the oil price increase of August 1990; the program envisages no change in the overall deficit and financing requirements though some components above the line may be affected.

2/ Includes net lending.

3/ Includes adjustments to overall deficit and financing targets for shortfalls in reconstruction expenditure and its financing as provided in the program.

4/ Includes the central government and 12 major nonfinancial public corporations.

deficit by about 1 percent of GDP and large net repayments to the banking system.

Revenue measures introduced in the 1990 budget were expected to yield about 1 percent of GDP. ^{1/} Owing to higher-than-expected nominal GDP, sale of capital assets and additional revenue measures, revenue is now projected to be larger in nominal terms than envisaged in the original budget. Nevertheless, the ratio of revenue to GDP--at 20.3 percent--is lower than in 1989, when the ratio was exceptionally high reflecting one time measures amounting to almost 2 percent of GDP.

The budget for 1990 envisaged a decline in the ratio of total expenditure to GDP (including net lending) to 31.7 percent from 32.8 percent in 1989, with reductions foreseen in both current and capital components. Despite the subsequent approval of large supplementary appropriations, total expenditure is now programmed to be only 31.2 percent of GDP because of the sharp rise in nominal GDP owing to inflation. Additional appropriations are to cover six main items: (a) a rise in defense expenditure from 3 1/2 percent of GDP to 5 percent owing to the insurgency in the North and East; (b) costs of restructuring and retrenchment in the central government and the CTB; ^{2/} (c) increased net lending for a fully foreign-financed electricity project (through an on-lending arrangement); (d) higher interest costs arising from domestic interest rates above those assumed in the budget; (e) increased appropriations for the school meal program; and (f) additional expenditure on teachers' salaries.

The authorities recognize that fiscal targets for 1990 will have to be met primarily by restraining expenditure, for which five conditions are critical: first, that a second round of expenditure under the JSP

^{1/} The 1990 budget did not incorporate certain discretionary measures that had been anticipated under the second SAF arrangement: excises on additional products were deferred pending revisions to the new excise law, and some tax concessions were continued in the light of financial difficulties faced by some companies owing to the economic disruptions of the previous year. Instead, a number of compensating measures were implemented including higher excises on tobacco and alcoholic beverages, turnover tax on some nonessentials, and a number of other minor adjustments in taxes on companies and higher fees and charges.

^{2/} The expenditure incurred in restructuring the CTB includes compensation packages for the 10,000 workers who have already taken voluntary redundancy, rehabilitating the fleet prior to the break up of the organization, and clearing the large arrears to domestic suppliers and creditors that have accumulated over the past years. The budgetary cost in 1990 is estimated to be SL Rs 675 million (or 0.5 percent of GDP) for the Government, and SL Rs 1,600 million for the CTB. The framework for these exercises has been provided by the World Bank's economic restructuring credit (ERC).

should not be initiated in 1990 and the cost of the school meal program is kept below the approved levels (further discussion of welfare expenditure is in Section III.4b(1)); second, that the wage bill is contained by rigorous application of the hiring freeze that is already in place and by allowing no further wage increases this year (lower-paid employees were allowed a small increase in January 1990); third, that subsidies are not allowed to re-emerge on any of the items (wheat, rice, fertilizer) for which subsidies were eliminated in the first part of 1990; fourth, that the expenditure on reconstruction and rehabilitation in the North will fall far short of the budgeted sharp increase in view of the uncertain situation there; and fifth, that there is no additional expenditure on defense over and above that already approved to support the operations in the North and East.

Based on the initial projections of revenue and expenditures, preliminary discussions were held on the 1991 budget, which will be presented to the Parliament later in the year. Two main considerations were identified: first, continued deficit reduction; and second, the substantial shift that is occurring in the structure of expenditures. The authorities recognize the need to reduce the deficit, so as to avoid inflationary bank financing, but stress the importance of maintaining certain types of expenditure. In particular, they believe that any further erosion of the investment budget would diminish the momentum of growth, in view of the steady compression during the past decade. They also point to the rising burden of debt service on the budget, observing that the primary (noninterest) deficit has fallen more quickly than the overall deficit in recent years. ^{1/} The authorities concur with the staff that the gradual increase in transfers and subsidies during recent years should be reversed but believe that too rapid a restructuring of welfare expenditure could lead to increasing social tensions.

On the revenue side, the authorities are taking a longer-term view. In preparation for the 1991 budget and to overhaul the tax system, the authorities established a Taxation Commission, which has received Fund technical assistance in the formulation of its recommendations. The Commission's terms of reference included simplifying the existing tax structure, broadening the base, increasing the elasticity of the system, and improving tax compliance. The authorities anticipate that these recommendations may have a negative net impact on the revenue effort. For these reasons, they expect to implement the Commission's recommendations gradually, especially the anticipated move toward a value-added tax which is likely to take several years. Revenue considerations are also playing a part in determining the pace of the next stage of trade liberalization, the introduction of a four-band tariff system, which the authorities have

^{1/} Indeed, between 1986 and 1990 the primary deficit--the overall deficit less interest costs--declined by about 1 percent of GDP more than the overall deficit.

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 remained broadly unchanged at the low annual rate of 2 percent during the first half of 1990. With the continuation of tight fiscal policies, credit to the public sector fell by 11 percent 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

credit ceilings ^{1/} and the requirement that commercial banks should hold an interest-bearing deposit against letters of credit for most luxury goods. In addition, refinance will be held broadly unchanged at the June 1990 level; over the longer term, the authorities acknowledge the desirability of phasing out refinance at preferential interest rates, observing, however, that most competitor countries offer similar or more extensive schemes.

The program aims at limiting liquidity growth to 15 percent in 1990 and to 14 percent in 1991, significantly below nominal GDP growth, particularly in 1990. In support of these targets, domestic credit expansion would be held to 12 percent in 1990 and 6 percent in 1991 (Table 6). In an important change from earlier years, the Government will not represent a significant source of credit expansion, given the low growth in its bank borrowing requirement projected in 1990 and substantial repayments in 1991. The pace of credit expansion to the rest of the public sector is expected to decelerate into the single digit range during 1991, with stronger tea prices and production having helped the state-owned plantation corporations in early 1990, and steps toward commercialization resulting in greater efficiency in other public corporations. With these measures, it will be possible to accommodate private sector credit expansion of about 17 percent in both years to facilitate the recovery of the sector from the difficult period in 1988-89. Domestic credit targets are slightly higher than would have been the case without the recent weakening in the external environment; this reflects higher working capital needs and lower liquidity in the enterprise sector, but takes account of the anticipated tightening of policy which will minimize the demand for additional credit.

3. External policies

The balance of payments, which strengthened markedly in the latter part of 1989, showed further improvement in the first half of 1990, with a surplus of about SDR 93 million, allowing all short-term borrowing by the Central Bank to be paid off. In the first half of 1990, gross official reserves grew by another SDR 36 million, improving marginally the ratio to the equivalent of 1.6 months of the current year's imports. Notwithstanding the improvement so far, the mission noted that the prospect of significant defense-related imports, a bunching of debt service payments in the second half of the year, and uncertainties in external conditions indicate the need for caution in financial and reserve management in the months ahead. A significantly less favorable balance of payments prospect for the second half of the year is expected

^{1/} These ceilings apply to some 30-40 percent of commercial bank credit, exempting credit for agriculture, exports, and industry, and a few public corporations.

Table 6. Sri Lanka: Monetary Developments, 1985-91

| End of period | 1985 | 1986 | 1987 | 1988 | 1989 | | 1990 | | 1991 |
|-----------------------------------|-------|-------|-------|-------|---------|--------|----------------|------------|-------|
| | | | | | Prog.1/ | Actual | Orig. prog. 1/ | Rev. Prog. | Proj. |
| (In billions of Sri Lanka rupees) | | | | | | | | | |
| Monetary survey | | | | | | | | | |
| Net foreign assets | 5.3 | 3.7 | 3.2 | -0.3 | -7.9 | -3.3 | -6.9 | -0.5 | 6.0 |
| Monetary authorities | 3.6 | 1.6 | 0.6 | -2.6 | -12.3 | -5.1 | -10.0 | -2.3 | 3.6 |
| Commercial banks | 1.7 | 2.0 | 2.7 | 2.3 | 4.5 | 1.8 | 3.0 | 1.9 | 2.4 |
| Net domestic assets | 41.7 | 46.0 | 53.3 | 66.4 | 79.8 | 75.6 | 88.7 | 83.8 | 89.5 |
| Domestic credit | 59.5 | 64.5 | 75.2 | 96.6 | 108.3 | 101.3 | 118.2 | 113.8 | 121.0 |
| Public sector | 25.4 | 27.9 | 34.2 | 46.7 | 55.2 | 49.0 | 57.7 | 52.4 | 49.4 |
| Government (net) | 21.0 | 23.1 | 26.9 | 35.9 | 39.9 | 35.2 | 40.9 | 36.2 | 31.7 |
| Public corporations | 4.4 | 4.7 | 7.4 | 10.8 | 15.3 | 13.9 | 16.8 | 16.2 | 17.7 |
| Private sector | 34.1 | 36.6 | 41.0 | 49.9 | 53.1 | 52.3 | 60.5 | 61.4 | 71.6 |
| Other items (net) | -17.8 | -18.5 | -21.9 | -30.3 | -28.5 | -25.7 | -29.5 | -30.0 | -31.5 |
| Monetary liabilities | 47.1 | 49.7 | 56.6 | 66.0 | 71.9 | 72.3 | 81.7 | 83.3 | 95.4 |
| Money | 18.7 | 21.1 | 24.9 | 32.2 | 34.9 | 35.1 | 39.2 | 40.8 | 44.9 |
| Currency | 9.8 | 11.6 | 13.5 | 18.5 | 19.7 | 19.7 | 22.2 | 23.3 | 25.8 |
| Demand deposits | 8.8 | 9.5 | 11.4 | 13.7 | 15.2 | 15.4 | 17.0 | 17.5 | 19.1 |
| Quasi-money | 28.4 | 28.6 | 31.7 | 33.9 | 37.0 | 37.2 | 42.6 | 42.5 | 50.6 |
| Monetary authorities | | | | | | | | | |
| Net foreign assets | 3.6 | 1.8 | 0.6 | -2.6 | -12.4 | -5.1 | -10.0 | -2.4 | 3.6 |
| Net domestic assets | 13.2 | 16.4 | 18.7 | 28.2 | 38.2 | 31.9 | 39.2 | 30.8 | 25.5 |
| Reserve money | 16.9 | 18.0 | 19.3 | 25.6 | 25.9 | 26.8 | 29.2 | 28.9 | 29.1 |
| (Twelve-month percentage change) | | | | | | | | | |
| Monetary survey | | | | | | | | | |
| Total domestic credit | 19.8 | 8.3 | 16.7 | 28.4 | 12.0 | 4.9 | 9.2 | 12.3 | 6.3 |
| Public sector | 34.9 | 9.7 | 22.8 | 36.4 | 18.2 | 5.0 | 4.6 | 6.8 | -5.7 |
| Government (net) | 42.8 | 10.3 | 16.1 | 33.7 | 11.1 | -2.1 | 2.5 | 2.8 | -12.4 |
| Public corporations | 7.0 | 6.8 | 55.4 | 46.4 | 41.7 | 28.5 | 10.0 | 16.9 | 9.3 |
| Private sector | 10.6 | 7.9 | 12.0 | 21.8 | 6.3 | 4.7 | 13.9 | 17.5 | 16.6 |
| Monetary liabilities | 12.3 | 5.6 | 13.8 | 16.7 | 8.9 | 9.5 | 13.7 | 15.3 | 14.4 |
| Money | 12.1 | 12.8 | 18.3 | 29.1 | 8.6 | 9.1 | 12.2 | 16.4 | 9.8 |
| Currency | 14.6 | 17.9 | 15.6 | 37.0 | 6.3 | 6.3 | 12.7 | 11.2 | 8.7 |
| Demand deposits | 9.4 | 7.2 | 20.3 | 19.9 | 11.5 | 13.0 | 11.5 | 9.1 | 9.5 |
| Quasi-money | 12.5 | 0.8 | 10.6 | 7.0 | 9.2 | 9.9 | 15.1 | 14.2 | 19.0 |
| Monetary authorities | | | | | | | | | |
| Net domestic assets | ... | 23.8 | 14.1 | 50.8 | 35.5 | 13.1 | 2.6 | -3.4 | -17.2 |
| Reserve money | 23.3 | 6.7 | 6.9 | 32.6 | 1.2 | 4.8 | 13.0 | 8.0 | 4.1 |
| Memorandum item: | | | | | | | | | |
| M2 multiplier 2/ | 2.79 | 2.76 | 2.93 | 2.58 | 2.78 | 2.70 | 2.80 | 2.88 | 3.17 |
| Three month treasury bill rate | 14.0 | 11.0 | 10.8 | 18.7 | ... | 16.4 | ... | ... | .. |

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

1/ As envisaged in the second-year SAF arrangement (EBS/89/186, 9/20/89).

2/ Broad money (M2) divided by reserve money.

even with such cautious policies, the need for which has been underscored by recent events in the Middle East.

The program envisages an overall balance of payments surplus of SDR 9 million in 1990 compared with a deficit of SDR 67 million in 1989 (Table 7). The improvement is largely attributable to an improved capital account, reflecting greater net inflows to public enterprises for infrastructural projects and higher disbursements from a number of concessional, policy-based loans that have already been committed. The current account, at 8 percent of GDP, is projected to be virtually unchanged from 1989, as a strong export performance will be offset by defense-related imports. Although the anticipated return of domestic stability and the continuation of sound financial policies in 1991 will help to strengthen the external accounts, these effects will be offset by higher oil prices and lower private transfers. Thus, the current account deficit is expected to decline by only 1 percent of GDP, and the overall balance would record a small deficit. To permit modest accumulation of gross official reserves to about seven weeks of import coverage by end-1991, a financing gap is shown for both 1990 and 1991. The gap is expected to be filled entirely, as an adequate amount of quick-disbursing loans from both the World Bank and the Asian Development Bank is currently at an advanced stage of preparation.

The devaluation of the rupee in late 1989 undoubtedly contributed to the revival of business confidence, the improved current account performance, and the consequent rise in the international reserves. Subsequent stability of the rate may have helped to maintain this confidence. Nevertheless, recent months have witnessed high inflation--leading to a significant appreciation in the real effective exchange rate (Chart 4)--and slower reserve accumulation suggesting that a review of exchange rate policy was timely. The authorities were intent upon avoiding any measure that would intensify inflationary pressures, and so were not considering a major discrete adjustment of the exchange rate. The mission took the position that the immediate priority should indeed be to reduce inflation by pursuing tight financial policies, and at the same time to modify the exchange system to permit greater market orientation in determining the exchange rate. Prevailing economic conditions were favorable, in particular the relatively strong reserve position, the recovery of exports, strong business confidence, and the absence of a significant premium in the parallel markets.

On August 20, 1990, the authorities introduced a system under which the Central Bank sets daily a reference exchange rate, which is a weighted average of the previous day's spot transactions in the local interbank market and which serves as the Central Bank's initial central rate for the day. During the course of the day, the central rate is adjusted--within a predetermined and unannounced band around the reference rate--depending on market conditions and the Central Bank's overall balance of payments policies--which will be guided by the need

Table 7. Sri Lanka: Balance of Payments, 1985-91

| | 1985 | 1986 | 1987 | 1988 | 1989 | | 1990 | | 1991 |
|--|--------|--------|--------|--------|----------|--------|----------------|------------|--------|
| | | | | | Prog. 1/ | Actual | Orig. Prog. 1/ | Rev. Prog. | Prog. |
| (In millions of SDRs) | | | | | | | | | |
| Current account | -582 | -516 | -404 | -449 | -557 | -425 | -480 | -484 | -448 |
| Trade balance | -711 | -649 | -525 | -568 | -629 | -542 | -546 | -602 | -562 |
| Exports | 1,296 | 1,030 | 1,077 | 1,098 | 1,163 | 1,206 | 1,278 | 1,393 | 1,551 |
| Imports | -2,007 | -1,678 | -1,602 | -1,666 | -1,792 | -1,748 | -1,825 | -1,995 | -2,113 |
| Services, net | -133 | -109 | -121 | -119 | -151 | -117 | -151 | -117 | -111 |
| Of which: interest payments 2/ | -175 | -143 | -130 | -148 | -164 | -151 | -163 | -157 | -163 |
| Private transfers, net | 262 | 242 | 242 | 238 | 223 | 234 | 217 | 236 | 225 |
| Capital account | 500 | 433 | 375 | 347 | 386 | 374 | 402 | 464 | 443 |
| Official transfers, net | 172 | 153 | 139 | 154 | 144 | 145 | 145 | 118 | 152 |
| Nonmonetary capital, net | 328 | 280 | 235 | 192 | 242 | 228 | 257 | 347 | 291 |
| Direct investment | 25 | 24 | 45 | 32 | 16 | 13 | 23 | 17 | 23 |
| Private long-term, net | 31 | 16 | 7 | -34 | -29 | -37 | -25 | -21 | -23 |
| Short-term, net | 3 | -11 | 31 | 12 | 75 | 83 | 10 | 28 | 17 |
| Government, long-term, net | 270 | 251 | 153 | 182 | 181 | 169 | 250 | 323 | 274 |
| Inflows | 342 | 350 | 265 | 304 | 305 | 291 | 353 | 422 | 380 |
| Outflows | -72 | -99 | -112 | -122 | -124 | -122 | -103 | -99 | -105 |
| Errors and omissions (including valuation adjustment) | -28 | 23 | -32 | 39 | — | -16 | — | 28 | — |
| Overall balance | -110 | -60 | -62 | -64 | -170 | -67 | -78 | 9 | -5 |
| Monetary movements | 110 | 60 | 62 | 64 | 170 | 67 | 78 | -9 | 5 |
| Use of gross official reserves | 112 | 124 | 94 | 5 | 52 | -17 | -45 | -22 | -46 |
| Use of Fund credit | -36 | -59 | -69 | 89 | 21 | 21 | 13 | 13 | -64 |
| Purchases | — | — | — | 153 | 67 | 67 | 45 | 45 | — |
| CFF | — | — | — | 109 | — | — | — | — | — |
| SAF | — | — | — | 45 | 67 | 67 | 45 | 45 | — |
| Repurchases | -36 | -59 | -69 | -64 | -46 | -46 | -32 | -32 | -64 |
| Net Central Bank borrowing | 8 | -1 | 40 | -39 | 128 | 45 | -50 | -45 | — |
| Rest of banking system, net | 26 | -4 | -2 | 9 | -30 | 18 | 30 | — | — |
| Financing gap | — | — | — | — | — | — | 130 | 46 | 115 |
| Memorandum items: | | | | | | | | | |
| Gross official reserves | 421 | 297 | 203 | 206 | 142 | 224 | 187 | 246 | 292 |
| In months of same year imports | (2.5) | (2.1) | (1.5) | (1.5) | (0.9) | (1.5) | (1.2) | (1.5) | (1.7) |
| Net official reserves | 120 | 60 | -1 | -56 | -268 | -105 | -186 | -50 | 60 |
| (In percent) | | | | | | | | | |
| Current account/GDP | -9.9 | -9.5 | -7.8 | -8.7 | -10.3 | -7.8 | -9.3 | -8.1 | -7.0 |
| Debt service ratio 3/ | 17.9 | 21.7 | 23.1 | 24.3 | 22.6 | 20.5 | 19.1 | 17.0 | 17.9 |
| Of which: IMF | 3.3 | 4.9 | 5.3 | 5.2 | 4.4 | 3.8 | 2.9 | 2.6 | 3.8 |
| Debt/GDP ratio | 56.8 | 62.5 | 66.8 | 71.9 | 76.2 | 72.6 | 86.4 | 72.2 | 72.1 |

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

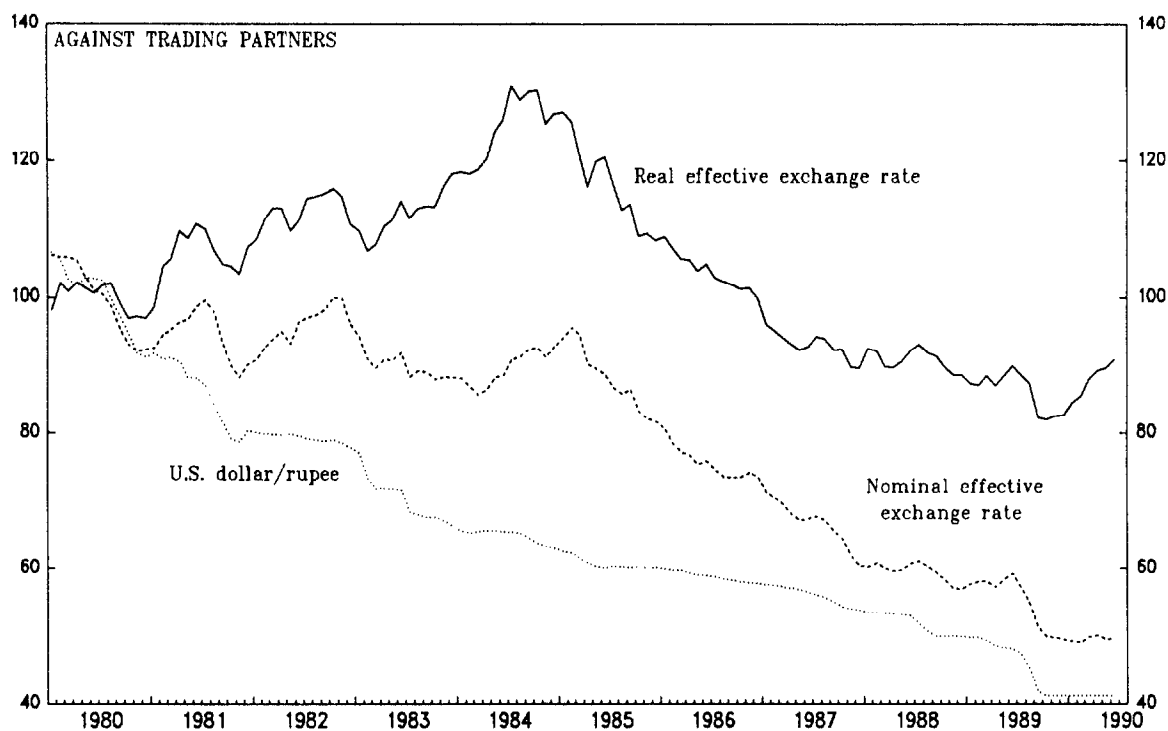
1/ As envisaged in the second-year SAF arrangement (EBS/89/86, 9/20/89).

2/ Excludes Central Bank's accrued interest on foreign securities that are purchased during the year.

3/ Debt service as a percent of current account receipts.

CHART 4

SRI LANKA
EXCHANGE RATE INDICES, JANUARY 1980-JUNE 1990 1/
(1980=100)



Sources: IMF, Information Notice System; and staff estimates.

1/ An increase indicates an appreciation.

2/ Major competitor countries weighted by their importance as supplier of primary, manufacturing, or total exports.

to accumulate reserves and maintain experience 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.

b. Public expenditure

The Government is reviewing the structure of public expenditure, concentrating on transfers and subsidies, and on public investment.

(1) Transfers and subsidies

Already major progress has been made with the elimination of certain large subsidies--fertilizer, wheat, and rice--and the reduction in transfers to corporations that has been possible with improving financial conditions in certain public corporations. However, transfers to households, as noted in Section III.2a, have grown substantially, largely because of the advent of the Jana Saviya program and the expansion of the coverage of the existing food stamp and school meal programs and increase in the value of the benefits.^{1/} With over one half of the population receiving food stamps, and by virtue of this also being eligible for consideration under the JSP, the authorities now recognize that the cost of these programs should be reduced.

First, the JSP, which in its initial formulation would have been prohibitively expensive, was deferred for a time and phased over a long period. The Government is now preparing, in consultation with the World Bank, an employment and poverty alleviation program, which, while targeted to a smaller number of beneficiaries and with lower benefits than the JSP, would obviate the need for the phased and selective approach currently in effect. Second, the Government has redefined the school meal program to provide essential food items to children in low-income families through means of special food stamps; pilot studies suggest that the participation rate will drop by some 30-40 percent. Third, the authorities are to undertake a comprehensive review of the food stamp program, to reduce the beneficiaries to about half the current level, while at the same time increasing the benefits to remaining families. This will be done in such a way that the nominal cost of the program in 1991 will not be allowed to increase above the level budgeted for 1990. By these means, the authorities intend to hold the expenditure on the three welfare programs to less than 3 percent of GDP in 1990 and 1991.

(2) Public investment

Public investment has been compressed from over 15 percent of GDP in the early 1980s to about 9 percent in 1990, a level that the authorities plan to continue into 1991, subject to the availability of resources. In this context, the authorities have recently conducted a preliminary study to identify a core investment program consisting of

^{1/} A further description of the JSP is to be found in EBS/89/186, 9/20/89, and in the forthcoming report of recent economic developments.

adequately funded projects with high economic returns that would need to be protected in the event of unexpected budgetary constraints. The staff endorsed the comprehensive review of investment anticipated under the World Bank's Economic Restructuring Credit (ERC), intended to identify the projects of the highest priority so as to increase the efficiency and to reduce the domestic resource cost of public investment. Moreover, the staff observed that containing public expenditure would allow a greater share of total investment to be undertaken by the private sector. The authorities, while broadly concurring with these views, are also mindful of the infrastructural and resource requirements of rehabilitating parts of the country most seriously affected by the civil conflict. Such projects, when implemented, would limit the potential for further compression.

5. Industrial policy and public enterprises

The strategy to improve the environment for trade and industry is multifaceted: strengthening the public enterprise sector including privatization; liberalizing the trade regime; reducing the regulation of business activity; and promoting foreign investment.

The Government's policy is to convert existing public enterprises to public companies, with a view to eventual privatization, or liquidating those activities that cannot be sustained. Through mid-1990 the sale of three companies had been completed--United Motors and two textile mills--and three more were at an advanced stage of divestiture--Ceylon Oxygen, a porcelain company, and a hotel. A project is under way, with the assistance of the World Bank, to restructure and divest all the public manufacturing enterprises in the textiles and industry sectors. Early candidates will include corporations involved in ceramics, hardware, plywood, tires, and leather.

The Government is extending the principle of private ownership and operation into other sectors of the economy. The Central Transport Board (the state-owned bus company) has been wound up and its assets divided among about 50 regional companies. About 10,000 workers (20 percent of the work force) have been laid off under a voluntary retrenchment plan, and further reductions are anticipated, as stricter staffing practices are introduced in the new companies. The Telecommunications Department was converted to a public liability company ^{1/} in June 1990, the final stage prior to full privatization, which may take a further 1-2 years. The state-owned plantation sector, which accounts for about two thirds of tree crop production, has been in troubled financial health for many years. The recent rise in tea prices and some short-term measures to reduce labor costs have temporarily eased the situation, but longer-term remedies are called for. In

^{1/} A company that has issued tradable equity that is entirely held by the Government.

consultation with the World Bank, the Government is preparing an action plan for possible moves toward eventual privatization; however, this remains one among many options for strengthening the finances of the industry including improved management and labor productivity and decentralization.

The authorities observed that the pace at which privatization can proceed through direct flotation on the domestic capital market is limited by the current small size of the Sri Lanka market. Therefore, a number of different strategies are being adopted including direct sales to private domestic or foreign buyers, joint ventures, and employee buyouts. Such considerations have also hastened moves toward opening up the local equity market to foreigners. In 1989, the 100 percent tax on equity transfers between foreigners was suspended. The more significant move, however, was the suspension of this tax on transfers of equity between Sri Lanka citizens and foreigners, for foreign equity participation up to 40 percent. This is a move that, despite unsettled conditions, has proved appealing to a number of portfolio funds that have recently begun investing in the domestic securities market. The authorities are examining remaining foreign exchange regulations on capital transactions to ensure that investors are able to effect transfers with sufficient flexibility. 1/

The industrialization strategy announced in December 1989 was designed to stimulate new investment, both domestic and foreign, through the creation of an environment that facilitates, rather than regulates, industry. New tax incentives were announced for re-equipping and updating industry, with even stronger incentives for pioneering industries. Also, consistent with this strategy, the Government has sought to diminish remaining regulations, including: (a) liberalizing shipping in January 1990, which allowed shipping rates to come down by 40 percent; 2/ (b) air freight to be liberalized in mid-1990; and (c) implementing a committee's recommendations to reduce bureaucratic impediments to business activity. Finally, the authorities intend to reduce the effective rate of protection over time and rationalize the tariff system. To this end, the maximum tariff will be reduced from 60 percent to 50 percent in the 1991 budget, and work on the new four-band system of tariffs will be completed for implementation with the 1992 budget. Budgetary considerations preclude more rapid progress on this measure (see Section III.2a).

1/ For instance, prior Central Bank approval is required for individual capital transfers in excess of SL Rs 350,000 (about US\$9,000).

2/ The authorities are now concerned with the implications for the financial health of the Ceylon Shipping Corporation, which they believe is being undercut by foreign competitors. They believe that a national carrier is essential, but that its existence may now be threatened.

6. Financial sector

The authorities are conscious that if the measures introduced elsewhere in the economy are to succeed then they must be supported by an efficient financial sector and an environment in which an effective monetary policy can be implemented through the use of indirect market-related instruments. The authorities intend to adopt a number of reforms, including the following: (a) gradually do away with the selective quantitative controls on credit; (b) vary Bank rate according to developments in the treasury bill market; (c) review the procedures for selling treasury bills so as to make interest rates more market determined and to facilitate open market operations; (d) extend the range of securities available to 3-10 years' maturity; (e) review the extent of refinancing facilities at preferential rates; and (f) review the current system of reserve requirements, possibly to exclude treasury bills and similar bonds. To make these measures effective the Central Bank would need to strengthen the framework for monetary management (the weekly treasury bill auction, and policies on reserve requirements and Bank rate) by preparing a monthly assessment of monetary conditions and by establishing a special unit to conduct reserve money programming.

Certain measures have been introduced to strengthen the financial system. The law was amended in 1988 to increase the supervisory capacity of the Central Bank with respect to the finance companies. The Central Bank also intends to strengthen bank supervision by introducing more rigorous loan classification and provisioning guidelines by the end of 1990. New debt recovery legislation was enacted in early 1990, although it is being amended to allow for more effective enforcement procedures. The financial health of the two state banks, which account for some 70 percent of commercial bank assets in Sri Lanka, is critically important. A number of steps are being taken to strengthen the financial position of these two banks with a view to the possibility of privatization: (a) appropriate provisioning practices; (b) strengthening loan recovery procedures; (c) reducing intermediation costs by administrative and managerial measures and rationalizing their branch networks; (d) improving credit delivery; and (e) strengthening their capital base.

7. Social impact of adjustment policies

The impact on the lowest income groups of the adjustment program supported by the third annual SAF arrangement should be less than in the previous program year, when the prices of many commodities consumed by these groups were adjusted following the removal of subsidies. The efforts to target the Government's principal social programs--Jana Saviya, school meals, and food stamps--will ensure that truly indigent households are protected from further price increases. Moreover, the efforts to restructure the Jana Saviya program so as to implement the program on an island-wide basis will mean that the protection will be universally available to the truly needy. Similarly, the proposal to

raise food stamp benefits to those who remain in the program will ensure a higher degree of protection to the needy. The Government also intends to preserve health and education expenditure in the face of other budgetary constraints. The authorities are deeply conscious of the falling value of real earned incomes in the light of recent high inflation, but recognize too the danger of rekindling inflation through large wage increases. Nevertheless, some adjustment may be contemplated, particularly in 1991 for low-income workers in the public sector. The various retrenchment programs highlight the need to promote alternative forms of employment, one reason for the authorities' urgent desire to stimulate new investment in the private sector.

8. Program benchmarks

Progress under the program for 1990-91 and the appropriateness of policies will be monitored through the proposed quantitative and structural benchmarks specified in Tables 1 and 2 of the Memorandum on Economic and Financial Policies (Attachment II). These benchmarks would provide early signals of the need for additional measures, should they become necessary for achieving the program's objectives.

The quantitative benchmarks include: (a) ceilings on the net domestic assets of the monetary authorities, and net domestic credit from the banking system, with subceilings on net bank credit to the central government and bank credit to the public corporations; (b) floors on net official international reserves; and (c) ceilings on the contracting or guaranteeing of new nonconcessional loans with 0-12 years' maturity by the nonfinancial public sector. The structural benchmarks include measures in the areas of: (a) central government revenue and tax administration; (b) public administration reform; (c) public enterprise reform; (d) trade liberalization; and (e) financial sector reform. In monitoring progress, World Bank views will be sought in the reforms of public administration, public enterprises, and trade policy.

IV. Medium-Term Prospects

1. Prospects for the balance of payments

Sri Lanka's medium-term prospects have strengthened well beyond the expectations of a year earlier notwithstanding recent adverse domestic and international developments. The rebound of the economy in late 1989 and early 1990, attributable to tight financial policies and improved security conditions, facilitated structural adjustment and was conducive to sustained growth. The resurgence of internal conflict in mid-1990 and the consequent diversion of resources to security have caused a severe setback. The fragility of stabilization gains that have been made is underscored by the persistence of a high rate of inflation and

the recent deterioration in the external economic environment, indicating that there is little margin for error. The discussions centered on policy measures over the medium term--the crucial elements being the restructuring of the public sector and fiscal restraint--that would be consistent with continued adjustment.

The base scenario (Table 8) assumes that the present domestic conflict would not create abnormal resource demands or disruption to economic activity beyond 1990, and that there is a gradual return to stability in external economic conditions so that the momentum of adjustment would be sustained. GDP growth is projected at about 5 percent, significantly faster than in recent years, with inflation falling to about 6 percent by 1993. Some improvement in the terms of trade is projected through 1993 reflecting a recovery in tea prices relative to imported food. Annual export volume growth is expected to be about 5-6 percent. A rapid increase in nontraditional export volumes (principally manufactured goods and minor crops) at about 13 percent annually is dampened by a much slower growth in the traditional exports, in which capacity constraints will be significant even if reform measures in the tree crop sector take effect. Import volume growth is expected to broadly match GDP growth. With virtually no rise anticipated in food imports--about two thirds of total consumer imports--a substantially higher expansion of intermediate and investment goods is possible.

The projections envisage that the current account deficit would be reduced to about 5 percent of GDP in 1993, a sustainable level. The projections of direct foreign investment and private capital flows remain cautious as the favorable response to the easing of restrictions in various areas would be dampened by renewed domestic disturbances. Thus, continued support by both bilateral and multilateral agencies will be required to support the adjustment effort. In order to achieve the target to build up external reserves to about three months of imports, significant financing gaps, currently projected to average SDR 95 million annually during the period 1991-95, would need to be filled. However, in view of the policy to restructure public expenditure and reorient the economy toward the private sector, the scenario assumes a decline in real terms of grants and official loans for project financing and envisages that the financing gaps would be filled by policy-based lending on concessional terms.

The scenario described above depends crucially on the assumptions that the current hostilities will not be prolonged, that there will be a gradual return to orderly conditions, and that the adjustment effort is vigorously sustained. Additionally, a high degree of uncertainty arises from the current conflict in the Middle East. The full-year impact of this conflict on the external accounts in the absence of any adjustment measures, would have been of the order of 1 percent of GDP, even on the assumption of gradually declining oil prices and increasing workers' remittances towards the end of 1991. The prompt response of the

Table 8. Sri Lanka: Medium-Term Scenario, 1987-95

| | 1987 | 1988 | 1989 | Projections | | | | | |
|--|--------|--------|--------|-------------|--------|--------|--------|--------|--------|
| | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
| (In millions of SDRs) | | | | | | | | | |
| Current account | -404 | -449 | -425 | -484 | -448 | -414 | -387 | -426 | -464 |
| Trade balance | -525 | -568 | -542 | -602 | -562 | -562 | -549 | -610 | -678 |
| Exports | 1,077 | 1,098 | 1,206 | 1,393 | 1,551 | 1,691 | 1,884 | 2,051 | 2,233 |
| Imports | -1,602 | -1,666 | -1,748 | -1,995 | -2,113 | -2,253 | -2,433 | -2,661 | -2,911 |
| Services, net | -121 | -119 | -117 | -117 | -111 | -96 | -84 | -50 | -30 |
| Of which: interest payments ^{1/} | -130 | -148 | -151 | -157 | -164 | -166 | -176 | -196 | -226 |
| Private transfers, net | 242 | 238 | 234 | 236 | 225 | 244 | 244 | 244 | 244 |
| Capital account | 375 | 347 | 374 | 464 | 443 | 412 | 431 | 450 | 487 |
| Official transfers, net | 139 | 154 | 146 | 118 | 152 | 156 | 159 | 164 | 170 |
| Nonmonetary capital, net | 235 | 192 | 228 | 347 | 291 | 256 | 272 | 292 | 317 |
| Direct investment | 45 | 32 | 13 | 17 | 23 | 30 | 42 | 54 | 65 |
| Private long-term, net | 7 | -34 | -37 | -21 | -23 | -23 | -19 | -18 | -11 |
| Short-term, net | 31 | 12 | 83 | 28 | 17 | 11 | 9 | 8 | 8 |
| Government, long-term, net | 153 | 182 | 169 | 323 | 274 | 237 | 240 | 248 | 255 |
| Inflows | 265 | 304 | 291 | 422 | 380 | 363 | 360 | 370 | 380 |
| Outflows | 112 | 122 | 122 | 99 | 105 | 125 | 120 | 122 | 125 |
| Errors and omissions (including valuation adjustment) | -32 | 39 | -16 | 28 | — | — | — | — | — |
| Overall balance | -62 | -64 | -67 | 9 | -5 | -2 | 43 | 30 | 23 |
| Monetary movements | 62 | 64 | 67 | -9 | 5 | 2 | -43 | -30 | -23 |
| Use of gross official reserves | 94 | 5 | -17 | -22 | -46 | -56 | -123 | -96 | -98 |
| Use of Fund credit | -70 | 89 | 21 | 13 | -64 | -54 | -18 | -9 | -22 |
| Purchases | — | 153 | 67 | 45 | — | — | — | — | — |
| CFF | — | 109 | 0 | 0 | — | — | — | — | — |
| SAF | — | 45 | 67 | 45 | — | — | — | — | — |
| Repurchases | -70 | -64 | -46 | -32 | -64 | -54 | -18 | -9 | -22 |
| Net Central Bank borrowing | 40 | -39 | 45 | -45 | — | — | — | — | — |
| Rest of banking system, net | -2 | 9 | 18 | — | — | — | — | — | — |
| Financing gap | — | — | — | 46 | 115 | 112 | 98 | 65 | 97 |
| Memorandum items: | | | | | | | | | |
| Gross official reserves | 203 | 206 | 224 | 246 | 292 | 348 | 471 | 557 | 655 |
| (In months of same year imports) | (1.5) | (1.5) | (1.5) | (1.5) | (1.7) | (1.9) | (2.3) | (2.5) | (2.7) |
| Net official reserves | -1 | -56 | -105 | -50 | 60 | 170 | 311 | 406 | 526 |
| (In percent) | | | | | | | | | |
| Current account/GDP | -7.8 | -8.7 | -7.8 | -8.1 | -7.0 | -5.9 | -5.1 | -5.1 | -5.1 |
| Debt service ratio ^{2/} | 23.1 | 24.3 | 20.5 | 16.9 | 17.0 | 17.4 | 14.9 | 14.0 | 14.5 |
| Debt/GDP ratio | 66.8 | 71.9 | 72.6 | 72.2 | 72.1 | 70.2 | 68.7 | 66.4 | 64.3 |
| Export volume (percent change) | 2.4 | 3.3 | 8.5 | 12.7 | 6.7 | 5.3 | 6.4 | 5.5 | 5.5 |
| Import volume (percent change) | 2.4 | 2.4 | -2.6 | 13.2 | 2.1 | 6.9 | 6.5 | 6.0 | 6.0 |
| Terms of trade (percent change) | 2.4 | -6.6 | -6.4 | 0.1 | 0.6 | 3.8 | 3.3 | — | — |

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

^{1/} Excludes Central Bank's accrued interest on foreign securities that are purchased during the year.

^{2/} Debt service as a percent of current account receipts.

authorities has reduced this impact by about one third, absorbing the balance by slower reserve accumulation. Should there be any further deterioration in the external environment beyond that which has been assumed, 1/ a substantial tightening of policies will be required.

2. Capacity to meet financial obligations to the Fund

Sri Lanka has maintained a consistently sound record for meeting its financial obligations to all external creditors, including the Fund. During the past year there has been a marked improvement in the country's official reserves, enabling all short-term borrowing contracted during 1989 to be repaid well ahead of expectations at the time the second SAF arrangement was approved. Moreover, during 1989 and 1990 there was considerably less medium-term commercial borrowing than had been anticipated a year earlier. The financing gaps shown in 1990 and 1991 are expected to be filled by quick-disbursing policy-based credits from the Asian Development Bank and the World Bank, which are at an advanced stage of preparation. Given the current policy of minimizing external borrowing on commercial terms, Sri Lanka's capacity to service its debt should continue to improve in future years. The debt service ratio, having peaked at 24 percent of current account receipts in 1988, fell appreciably to 21 percent in 1989, and is expected to decline further to 17 percent in 1990, dropping to 15 percent by 1993. Obligations to the Fund are projected to peak in 1991 at about 4 percent of current account receipts, falling to 1 percent by 1993; the concessionality of the SAF resources mean that this ratio would not increase in future years. Thus, notwithstanding the risks described above, in both the external and domestic conditions, Sri Lanka is expected to remain current on its obligations to the Fund.

V. Staff Appraisal

The Sri Lanka economy showed adaptability and resilience over the past year, producing an impressive turnaround in performance and prospects in response to the adjustment program introduced in the midst of difficult security conditions. Stronger financial management and improved security restored external viability from the near crisis of mid-1989. Output also responded strongly, with broad-based economic recovery taking place in most parts of the country. At the same time,

1/ The scenario assumes oil prices consistent with the Fund's current commodity price projections. Each \$1 deviation in the oil price will result in a change of SDR 9 million in the import bill (about 0.1 percent of GDP). Equally uncertain is the prospect for inward remittances; an estimated 30 percent of Sri Lanka's migrant workers were formerly employed in Iraq and Kuwait, and it has been assumed that one half of the remittances of these workers will be lost through mid-1991, with some recovery thereafter.

progress was made in the structural reform that was resumed concurrently with the adjustment program.

One disappointing feature--and a major one--in Sri Lanka's recent economic performance has been inflation. Initially responsible were devaluation and subsidy removal, some of which had much wider repercussions than had been anticipated. Subsequently, economic recovery created supply bottlenecks and business conditions more conducive to price increases, while faster liquidity growth resulting from external surpluses stimulated demand. More recently, inflation appears to have peaked, but at 20 percent it remains a cause of concern.

Sri Lanka's economic adjustment efforts now focus on the consolidation of the gains achieved thus far--slowing inflation, preserving external viability, and sustaining a more rapid rate of growth than had been thought possible a year ago. Structural reforms--to streamline the public sector and create an environment conducive to more vigorous private sector activity--will continue. The pursuit of these tasks poses a major challenge and is further complicated by the still uncertain domestic security outlook and recent events in the Middle East.

Controlling inflation and preserving external viability calls for tight monetary policy. Most importantly, interest rates need to be restored to positive real levels, to help restrain credit and absorb some of the liquidity that had been created as the external position strengthened. Already, key administered rates have been raised significantly but the staff believes that further increases are needed in the weeks ahead. In present circumstances, it is also necessary to continue to supplement market-based instruments with direct controls--including quantitative limits on selected credit and restraint on concessional refinance from the Central Bank--which have been executed forcefully during the last 12 months. At the same time, the reform of the financial sector should be accelerated so that monetary management can be conducted without recourse to direct credit control and through more freely determined interest rates. While the reform has been delayed because of pressing stabilization requirements, the staff believes that renewed efforts should now be made given recent improvements in economic conditions.

Reducing budgetary expenditure relative to GDP--and the budget deficit--is essential both to short-term demand management and longer-term restructuring of the economy. A number of constraints have limited faster progress in this area. The retrenchment of government employees, which has been proceeding at a relatively rapid pace, had only a limited immediate impact on the wage bill; reductions in social welfare programs had to be tempered by the need to protect the poor against the adverse impact of adjustment program; and economic recovery has heightened expectations of rising capital outlays. Moreover, large additional demands have arisen from the resurgence of fighting in the North and

East. Nevertheless, the staff believes that expenditure levels should and can be reduced relative to GDP. Efforts may be focused on social expenditure, where, with the application of appropriate targeting, significant reductions can be achieved while protecting the truly needy. Investment priorities should also be reviewed to adapt public investment to levels consistent with the declining size of the public sector, and an expected increase in private sector investment.

The staff shares the authorities' view that deficit reduction should come largely from the expenditure side, given the limited potential for revenue enhancement. However, with the time that is likely to be needed to achieve large reductions in expenditure, caution should be exercised in adopting measures that are likely to reduce the revenue effort significantly. Thus, the staff believes that one of the paramount considerations in the Government's implementation of the recommendations of the Taxation Commission should be to preserve broad revenue neutrality until expenditure reduction assures a sustainable fiscal balance.

Exchange rate policy has played a key role in Sri Lanka's adjustment program as a principal instrument in restoring confidence in economic institutions and policy. The devaluation of August-September 1989 and subsequent stability of the rupee have contributed significantly in this respect, not only by reversing short-term capital flows and strengthening external reserves, but also by restoring business confidence. The rapid consumer price inflation in the first half of this year has been reflected in a considerable appreciation of the real effective exchange rate index, but the country's external position has not yet been affected appreciably. In these circumstances, the staff believes that the priority should be to lower inflation. At the same time, a mechanism that is more responsive to changing economic and market conditions is called for. Toward this end, and as part of their efforts to enhance market orientation in economic management, the authorities have recently initiated a move toward an exchange system that allows the market to influence the exchange rate. The staff believes that this step, although small, is in the right direction and that the extent of the market's influence should be increased as the authorities gain experience in operating the new system.

The structural reform that resumed last year continues with increasing momentum. In the public sector, progress is being made to reduce the size and cost of government employment and to contain--especially through better targeting--the level of transfers. A number of public enterprises have been privatized or, as an intermediate step, commercialized with greater autonomy. For the private sector, especially for trade and industry, regulation is being diminished and incentives rationalized. This is expected to allow the private sector to increase its share of total investment. The financial sector reform represents a key element in transforming the economy and, as described above, efforts need to be made to accelerate progress.

Although less favorable than at the time of the discussions, the prospects for the medium term remain promising. The early suppression of inflation, combined with continued financial restraint and structural reform, should permit relatively rapid growth, while achieving a balance of payments that is sustainable. Although the deterioration in the external environment means that reserve replenishment will now be slower than initially hoped, the adjustment path remains viable. However, it is important that the authorities deepen and intensify their structural reforms so as to increase further their capacity to withstand such external shocks, to establish a strong balance of payments, and to achieve sustainable economic growth.

The authorities have demonstrated their commitment to reform, and their capacity to implement difficult stabilization measures even in the midst of very trying economic and political conditions. In particular, the authorities have responded promptly to the recent deterioration in the external environment by adjusting oil-related prices and tightening financial policy; they intend to take further measures as necessary. The staff believes that the policies and measures described in the Government's Memorandum on Economic and Financial Policies constitute an appropriate response to prevailing macroeconomic imbalances. The staff recommends approval of Sri Lanka's request for a third annual arrangement under the structural adjustment facility.

Sri Lanka maintains a system of international payments and transfers that is largely free of restrictions, with the exception of the restriction and the multiple currency practice described in Section III.3.

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

VI. Proposed Decisions

The following draft decisions are proposed for adoption by the Executive Board:

A. 1990 Article IV Consultation

1. The Fund takes this decision relating to Sri Lanka's exchange measures subject to Article VIII, Section 2(a) and 3, and in concluding the 1990 Article XIV consultation with Sri Lanka, in light of the 1990 Article XIV consultation with Sri Lanka conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. 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 Article XIV, Section 2; and the multiple currency practice arising from a stamp duty of 3 percent on letters of credit for imports, which is subject to approval under Article VIII, Sections 2(a) and 3. The Fund encourages Sri Lanka to eliminate the restriction on travel allowances as soon as circumstances permit and urges the early removal of the multiple currency practice arising from the stamp duty.

B. Structural Adjustment Arrangement

1. The Government of Sri Lanka has requested the third annual arrangement under the structural adjustment facility.
2. The Fund has appraised the progress of Sri Lanka in implementing the policies and reaching the objectives of the program supported by the second annual arrangement, and notes the updated policy framework paper contained in EBD/90/307.
3. The Fund approves the arrangement set forth in EBS/90/167.

Sri Lanka--Fund Relations
(As of July 31, 1990)

I. Membership Status

- (a) Date of membership: August 29, 1950
- (b) Status: Article XIV

A. Financial Relations

II. General Department

- (a) Quota: SDR 223.1 million
- (b) Total Fund holdings
of Sri Lanka rupees: SDR 366.1 million (164.2 percent of quota)
- (c) Fund credit:

| | <u>(SDR million)</u> | <u>(Percent of quota)</u> |
|---------------------------------|----------------------|---------------------------|
| Compensatory financing facility | 108.8 | 48.8 |
| Extended fund facility | 31.3 | 14.0 |
| Enlarged access resources | 3.0 | 1.3 |
| Structural adjustment facility | 111.5 | 50.0 |
- (d) Reserve tranche position: SDR 0.04 million

III. Current and Previous Arrangements and Special Facilities

- (a) Current arrangement: The first annual arrangement under a three-year structural adjustment arrangement was approved on March 9, 1988 and the second annual arrangement on October 11, 1989. The arrangement is in the amount of SDR 156.2 million (70 percent of quota), with SDR 111.5 million (50 percent of quota) already drawn under the first and second annual arrangements.
- (b) Previous stand-by and extended arrangements during the past ten years:
 - (1) December 2, 1977-December 1, 1978: Stand-by arrangement.
Amount: SDR 93.0 million; 94.9 percent of quota (full amount purchased).
 - (2) January 1, 1979-December 31, 1981: Extended fund facility arrangement.
Amount: SDR 260.3 million; 218.7 percent of quota, of which: SDR 80 million purchased in 1979; SDR 30 million purchased in 1980; SDR 150.3 million purchased in 1981.

Sri Lanka--Fund Relations (continued)

- (3) September 4, 1983-July 31, 1984: Stand-by arrangement.
 Amount: SDR 100 million; 44.8 percent of quota, of which:
 SDR 30 million purchased in 1983 and SDR 20 million
 purchased in 1984; the balance of SDR 50 million was
 undrawn after the arrangement became inoperative.

(c) Special facilities:

January 26, 1983: Buffer stock financing facility (rubber)
 Amount: SDR 5.8 million
 March 14, 1988: Compensatory financing facility
 Amount: SDR 108.8 million

IV. SDR Department

- (a) Net cumulative allocation: SDR 70.9 million
 (b) Holdings: SDR 0.5 million, or 0.7 percent of net cumulative
 allocation.

V. Administered Accounts

- (a) Trust Fund Loans:
 (i) Disbursed: SDR 95.8 million
 (ii) Outstanding: SDR 0.4 million
 (b) SFF Subsidy Account:
 Payments: SDR 0.59 million

VI. Financial Obligations Due to the Fund

| | 1990 (Aug.-Dec.) | 1991 | 1992 | 1993 | 1994 |
|------------------------------------|-----------------------|------|------|------|------|
| | (In millions of SDRs) | | | | |
| Principal | 11.6 | 63.9 | 54.4 | 18.1 | 8.9 |
| Repurchases | 11.6 | 35.6 | 54.4 | 13.6 | -- |
| Trust Fund loans | -- | 0.4 | -- | -- | -- |
| SAF loans | -- | -- | -- | 4.5 | 8.9 |
| Charges and interest ^{1/} | | | | | |
| Provisional | 10.4 | 18.3 | 12.2 | 7.6 | 6.9 |
| Total | 21.9 | 82.3 | 66.6 | 25.6 | 15.8 |

^{1/} Including Trust Fund obligations and net SDR charges.

Sri Lanka--Fund Relations (continued)

B. Nonfinancial Relations

VII. Exchange Rate Arrangement

Managed floating. With the exception of the limitations on the availability of foreign exchange for personal travel abroad which is maintained in accordance with the transitional arrangements of Article XIV, Section 2 and the multiple currency practice arising from a stamp duty of 3 percent on letters of credit for imports (which is subject to approval under Article VIII, Sections 2(a) and 3), the exchange system is free of restrictions on payments and transfers for current international transactions.

VIII. Last Article IV Consultation

The Executive Board discussed the staff report for the 1989 Article IV consultation (EBS/89/186) on October 11, 1989. The following decision was adopted:

1. The Fund takes this decision relating to Sri Lanka's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1989 Article XIV consultation with Sri Lanka, in the light of the 1989 Article IV consultation with Sri Lanka conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).
2. Sri Lanka's exchange system is free of restrictions on payments and transfers for current international transactions, except the restriction arising from the limitations on the availability of foreign exchange for personal travel abroad, which is maintained in accordance with Article XIV, Section 2, and the multiple currency practice arising from a stamp duty of 3 percent on letters of credit for imports, which is subject to approval under Article VIII, Sections 2(a) and 3. The Fund encourages Sri Lanka to eliminate the restriction on travel allowances as soon as circumstances permit and urges the early removal of the multiple currency practice arising from the stamp duty.

IX. Consultation Cycle

Sri Lanka is on the standard 12-month consultation cycle.

X. Technical Assistance

Sri Lanka has benefited in the past from extensive technical assistance in the fiscal, monetary, and statistical areas. The most recent developments are the following:

Sri Lanka--Fund Relations (concluded)

(a) CBD: In 1987 and also in 1988, CBD missions advised on improvements to the treasury bill auction system; a mission in which the International Finance Corporation participated, advised on the establishment and regulation of unit trusts. In 1989-90, two CBD technical experts assigned to Colombo prepared a set of proposals for reforms in the area of bank supervision. The second of these consultants was financed under a World Bank project. In March 1990, CBD participated in a World Bank financial sector review mission, and provided advice on the conduct of monetary policy.

(b) STA: Staff visits in 1987 and 1988 assessed progress in compiling accounts of public enterprises and made recommendations.

(c) FAD: In 1986, FAD experts reviewed tax administration, in particular the business turnover tax and excise duties and advised on the financial implications of the proposed devolution of selected central government functions to local governments. In November 1989 and March and July 1990 FAD provided assistance to the Taxation Commission which is expected to report in mid-1990. In February-March 1990 an FAD mission reviewed and advised upon tax administration, focusing on corporate taxation. This was followed up by the assignment of an advisor for three months to help in implementing some new administrative systems.

XI. Resident Representative

A resident representative has been stationed in Sri Lanka since October 1977. Mr. Harm Snoek took up this position in July 1990.

Sri Lanka - Relations with the World Bank Group 1/

1. Role of the World Bank in Sri Lanka

Since Sri Lanka became a member of the IBRD and IDA in 1954, the World Bank has approved 12 loans totaling \$181.2 million (net of cancellations) and 53 credits totaling \$1,210.1 million (net of cancellations). Sri Lanka became a member of the IFC in 1970 and seven investments totaling about \$39 million (gross) have been made to date. During FY 1987-FY 1990 the World Bank Group approved 11 credits (totaling \$452.8 million) and so far in FY 1991, no credit has been approved.

A central element of the World Bank's current strategy in Sri Lanka is the achievement of a more sustainable growth pattern in the medium term through export promotion and import substitution in viable economic activities. In line with this strategy, the Bank's lending program has been concentrating resources on directly productive sectors, such as agriculture and industry and in support of energy and transport infrastructure.

Bank/IDA lending in agriculture (about 39 percent of the total) has been focusing on the expansion of paddy production and rehabilitation of the vital tree crop subsector, activities in which Sri Lanka has a comparative advantage. IDA will continue to support the sectors through investment designed to remove bottlenecks to agricultural growth through investment in industry, and by strengthening extension services, research, and provision of irrigation.

Bank/IDA lending for industry (about 15 percent of the total) has supported a broad range of large-, medium-, and small-scale industrial enterprises, primarily in the private sector, through support of industrial development finance institutions. While continuing this support, future lending in this sector would focus on trade reform, the development of an export strategy, support of privatization of selected private enterprises, and increased efficiency of enterprises remaining in the public sector.

In transport, Bank/IDA lending (12 percent of the total) is directed at easing transport bottlenecks. It supports rehabilitation and upgrading of the road network, institutionalizing proper maintenance methods, and improving sectoral planning of policies and programs.

Bank/IDA lending for energy (17 percent of total) has provided financing to a number of power projects for generation, transmission,

1/ Prepared by World Bank staff.

and distribution. The future program will accord relative priority to energy conservation rather than generation, through appropriate investments and policy measures.

The Bank is also developing a number of projects in support of structural reforms under the SAF. Chief among these are the Economic Restructuring Credit (ERC) (approved in May 1990), the Public Manufacturing Enterprise Adjustment Credit (PMEAC), and the Poverty Alleviation Project (PAP). The ERC aims at supporting the program of reforms outlined in the PFP for 1989-92. The PMEAC aims at supporting the Government's plans for public enterprise reform and envisages privatization of a number of enterprises; the improvement in the efficiency of those enterprises that are to remain in the public sector; and the closure of public enterprises that cannot be transformed into viable concerns.

The PAP is currently scheduled for appraisal in November 1990 and aims at providing production-oriented substitute for the Government's Jana Saviya Program (JSP). It is expected that it will be presented to the Bank's Board in May 1991 and would consist of a combination of interventions including: (1) a credit line to the poor for self-employment and micro-enterprise development, including technical assistance, and entrepreneurial development; (2) a nutrition component; and (3) a rural works program aimed at providing wage employment to low-income families in areas of acute unemployment.

The Bank has chaired the annual Sri Lanka Aid Group meetings that provide a forum for aid donor consultation since the 1960s. Following the signing of the peace accord, a special meeting to help the Government mobilize and coordinate resources for a reconstruction program was held in December 1987 and was followed by the Annual Aid Group meetings in June 1988 and October 1989. The next Aid Group meeting is currently scheduled for October 25, 1990.

Latest World Bank Economic Reports: Sri Lanka - A Break with the Past: The 1987-90 Program of Economic Reforms and Adjustment, May 27, 1988; Sri Lanka - Recent Macroeconomic Developments and Adjustment Policies, December 18, 1989.

Sri Lanka: Lending by the World Bank Group, 1983-89

(In millions of U.S. dollars)

| | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|----------------------|------|------|------|------|------|------|------|
| IBRD (net) | 12.5 | 10.8 | 0.6 | -1.2 | -0.2 | 1.6 | 1.6 |
| Disbursements | 14.5 | 12.8 | 5.1 | 2.8 | 4.0 | 6.8 | 6.5 |
| Amortization | 2.0 | 2.0 | 4.5 | 4.0 | 4.2 | 5.2 | 4.9 |
| IDA (net) | 59.1 | 79.3 | 72.8 | 84.4 | 81.6 | 61.4 | 51.2 |
| Disbursements | 60.8 | 80.9 | 73.3 | 85.1 | 82.5 | 62.5 | 52.8 |
| Amortization | 1.7 | 1.6 | 0.5 | 0.7 | 0.9 | 1.1 | 1.6 |
| Total loans (net) | 71.6 | 90.1 | 73.4 | 83.2 | 81.4 | 63.0 | 52.8 |
| Interest and charges | 4.2 | 6.3 | 7.9 | 10.6 | 12.6 | 15.2 | 12.2 |
| IBRD | 2.5 | 4.2 | 5.1 | 6.8 | 7.4 | 8.3 | 7.3 |
| IDA | 1.7 | 2.1 | 2.8 | 3.8 | 5.2 | 6.9 | 4.9 |

Source: Data provided by the World Bank.

Sri Lanka--Relations with the Asian Development Bank

Role of the Asian Development Bank in Sri Lanka

Since approving its first loan to Sri Lanka in 1968, the Bank has made 56 loans to Sri Lanka, including six from its ordinary capital resources (OCR) 1/ and 50 from its concessional Asian Development Fund (ADF). The loan amount has totaled \$984.6 million, including \$14.1 million from OCR and \$970.5 million from ADF resources. During 1986-89 the Bank approved 15 loans totaling \$444 million; so far in 1990 one loan for \$74.3 million has been approved. The Bank has provided \$17.2 million 2/ as grant financing for technical assistance for project preparation and institution strengthening.

The basic objective of the Bank's operational strategy in Sri Lanka is to assist the country in addressing its structural adjustment issues in ways that support transformation toward a more market-based and export-oriented economy with full participation of the private sector. The Bank's strategy supports the Government's efforts to reduce the current macroeconomic imbalances including a large fiscal deficit, serious trade and current account deficits in the balance of payments, and a large and inefficient public sector.

Bank lending to agriculture (about 55 percent of the total) has been directed at improving the balance of investments across the subsectors in order to increase export earnings, with an emphasis on support for the tree crop subsectors. Special emphasis has been given to improving the institutional and policy environment in the sector. The Bank has supported rehabilitation of the agriculture sector in the aftermath of the civil disturbances. Proposed loans will continue to support the current strategy, as well as encouraging private investment through credit facilities to farmers. In the medium term, the agriculture sector will remain the most important area for Bank activities.

Bank lending to the financial and industrial sectors (accounting for about 12 percent of total lending) has focused on provision of credit lines through development finance institutions as a means of providing support for enhancing capacity utilization and establishment of new industries. More recently, the Bank has provided assistance for the development of the financial sector (especially in regard to the capital market) and has supported initiatives to improve the policy and

1/ The last OCR loan to Sri Lanka was approved in November 1974.

2/ Including \$4.5 million from the Japan Special Fund and \$2.5 million from other sources.

institutional framework of the sector. Future industrial sector operations will support divestiture of government-owned enterprises and increased private sector involvement.

In the energy sector (accounting for about 10 percent of total lending), the Bank has provided funding for generation, transmission and distribution projects, including assistance for the establishment of the Lanka Electric Company (Private) Limited. Future Bank operations in the power subsector will be consistent with the findings of the National Energy Strategy (1985), which was prepared with Bank assistance, and which identifies the need to improve operational efficiency and to conserve energy through demand management.

Bank lending to the transport and communication sectors (11 percent of the total) will be limited to rehabilitation of the road network and strengthening the domestic contractor (especially private firms) capacity in road construction and maintenance. In the communications sector, the Bank has recently moved from a project-by-project approach to a more comprehensive sector-wide approach, following completion of the Bank-assisted Telecommunications Development Study.

In the social sector (12 percent of the total), the Bank's activities in the sector have been selectively focused on housing development, improving the quality of education and its relevance to employment needs, institutional strengthening and manpower development in the health subsector, and improved policy environment in the water supply subsector.

The Bank has, or will, encourage policy reforms in various sectors under the umbrella of its program lending facility. Also, the Bank's operational program will continue to emphasize economy-wide issues relating to poverty alleviation, the environment and women in development. The Bank will monitor closely the Government's Janasavaya (poverty alleviation) program with a view to assessing an appropriate type and level of assistance. All Bank projects are assessed for their environmental impact, and technical assistance is proposed to review the current status of industrial pollution controls and regulations. Special attention will be given to the role of women, especially in the agriculture sector.

Sri Lanka: Lending by the Asian Development Bank, 1983-90

(In millions of U.S. dollars)

| | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 Proj. |
|----------------------|------|------|------|------|------|------|------|---------------|
| Net transfer | 28.2 | 25.5 | 28.6 | 38.1 | 45.6 | 61.1 | 72.9 | 83.8 |
| Disbursement | 29.4 | 26.8 | 29.9 | 40.4 | 48.5 | 64.8 | 77.0 | 88.4 |
| Amortization | 1.2 | 1.3 | 1.3 | 2.3 | 2.9 | 3.7 | 4.1 | 4.6 |
| Interest and charges | 1.5 | 1.6 | 1.8 | 2.6 | 3.3 | 4.1 | 4.2 | 5.0 |

Source: Asian Development Bank.

Sri Lanka: Selected Economic and Financial Indicators, 1987-91

| | 1987 | 1988 | | 1989 | | 1990 | | 1991 |
|---|--------|----------|--------|---------|--------|---------|--------------------|------------|
| | | Program | Actual | Program | Actual | Program | Revised Program | Projection |
| (Changes in percent) | | | | | | | | |
| Real GDP | 1.5 | 5-6 | 2.7 | 2.0 | 2.3 | 3.0 | 4.8 | 5.5 |
| GDP/deflator 1/ | 8.0 | 7-8 | 10.4 | 10.0 | 9.8 | 10.0 | 10.8 | 11.5 |
| Consumer prices 2/ | 10.2 | 7-8 | 15.0 | 12.0 | 11.6 | 10.0 | 10.5 | 10.0 |
| Nominal GDP (S.R. bn.) | 196.7 | 226.4 | 222.0 | 258.0 | 252.8 | 283.2 | 317.4 | 304.5 |
| Export volume | 2.4 | 5.1 | 3.3 | 2.6 | 8.5 | 6.9 | 12.7 | 6.7 |
| Import volume | 2.4 | 5.9 | 2.4 | -0.7 | -2.6 | 2.7 | 13.2 | 2.1 |
| Terms of trade | 3.4 | 3.3 | -9.1 | -6.1 | -5.9 | 3.7 | 0.1 | 0.6 |
| Exchange rates 3/ | | | | | | | | |
| Nominal effective | -18.1 | ... | -5.6 | ... | -13.2 | ... | -16.1 4/ | ... |
| Real effective | -10.3 | ... | -1.1 | ... | -5.2 | ... | 3.0 | -3.8 |
| U.S. dollar per rupee | -7.1 | ... | -6.9 | ... | -17.4 | ... | -10.5 | -6.8 |
| Rupees per U.S. dollar (level) | 30.8 | ... | 33.0 | ... | 40.0 | ... | 40.3 | 43.2 |
| Budget revenue | 13.2 | 9.7 | -0.9 | 27.3 | 31.8 | 11.4 | 12.5 | 11.4 |
| Budget expenditure and net lending | 7.9 | 7.5 | 19.8 | 10.3 | 8.2 | 8.4 | 19.7 | 7.6 |
| Domestic credit 5/ | 16.7 | 12.0 | 38.4 | 12.0 | 4.9 | 9.2 | 12.3 | 6.1 |
| Public sector | 22.8 | 10.4 | 36.4 | 18.2 | 5.0 | 4.6 | 6.8 | -5.7 |
| Private sector | 12.0 | 13.4 | 21.7 | 6.3 | 4.7 | 13.9 | 17.5 | 16.6 |
| Broad money 5/ | 13.8 | 14.4 | 16.7 | 8.9 | 9.5 | 13.7 | 15.1 | 14.4 |
| Narrow money | 18.3 | 14.1 | 29.1 | 8.6 | 9.1 | 12.2 | 16.4 | 9.8 |
| Quasi-money | 10.6 | 14.6 | 7.0 | 9.2 | 9.9 | 15.1 | 16.2 | 19.0 |
| Reserve money | 6.9 | 15.1 | 32.6 | 1.2 | 4.8 | 13.0 | 8.0 | 3.1 |
| Money (M2) velocity (average) | 3.7 | ... | 3.6 | 3.6 | 3.7 | 3.6 | 3.1 | 3.2 |
| Average lending rates (in percent) | 18.2 | ... | 18.1 | ... | 18.5 | ... | ... | ... |
| Average deposit rates (in percent) | 10.2 | ... | 10.2 | ... | 14.8 | ... | ... | ... |
| (In percent of GDP) | | | | | | | | |
| Budget | | | | | | | | |
| Deficit before grants (-) | -11.1 | -10.0 6/ | -15.7 | -12.6 | -11.0 | -10.1 | -10.4 7/ | 9.4 |
| Deficit after grants (-) | -8.7 | -8.1 6/ | -12.7 | -9.8 | -8.5 | -7.7 | -8.9 | -7.0 |
| Revenue | 21.4 | 20.7 | 18.8 | 21.4 | 21.8 | 21.6 | 20.3 | 19.5 |
| Expenditure | | | | | | | | |
| (including net lending) | 32.5 | 30.9 6/ | 34.5 | 33.9 | 32.9 | 31.7 | 31.7 | 28.9 |
| Domestic financing | 5.8 | 3.4 6/ | 9.5 | 6.4 | 6.1 | 4.0 | 3.5 | 7.2 |
| Of which: Bank | 1.8 | 0.6 6/ | 4.7 | 1.6 | -1.5 | 0.4 | 0.3 | -1.3 |
| Gross investment | 23.3 | 23.0 | 23.2 | 21.0 | 21.6 | 20.6 | 21.8 | 22.3 |
| National saving | 15.5 | 14.8 | 14.5 | 10.7 | 13.9 | 11.3 | 13.7 | 15.3 |
| Current account deficit excluding grants (-) | -7.8 | -8.2 | -8.7 | -10.3 | -7.8 | -9.3 | -8.1 | -7.0 |
| Debt service 8/ as percent of: | | | | | | | | |
| Exports of goods and services | 27.6 | 27.6 | 28.9 | 26.6 | 26.1 | 22.1 | 19.6 | 20.3 |
| Current account receipts | 23.1 | 23.4 | 24.3 | 22.6 | 20.5 | 19.1 | 17.0 | 17.9 |
| External debt 9/ in percent of: | | | | | | | | |
| Exports of goods and services | 249.2 | 259.3 | 264.5 | 285.4 | 241.8 | 283.2 | 232.9 | 284.3 |
| Nominal GDP | 66.8 | 72.9 | 71.9 | 76.2 | 73.0 | 86.4 | 72.2 | 71.1 |
| (In millions of S.Rs) | | | | | | | | |
| Exports | 1,077 | 1,186 | 1,098 | 1,163 | 1,206 | 1,278 | 1,393 | 1,351 |
| Imports | -1,502 | -1,729 | -1,666 | -1,792 | -1,748 | -1,825 | -1,995 | -2,113 |
| Current account | -404 | -433 | -449 | -557 | -425 | -480 | -483 | -648 |
| Overall balance | -62 | 4 | -64 | -170 | -67 | -78 | 9 | -5 |
| Gross official reserves | 203 | 255 | 206 | 142 | 224 | 187 | 246 | 322 |
| (months of current year imports) | 1.5 | 1.8 | 1.5 | 0.9 | 1.5 | 1.2 | 1.5 | 1.7 |
| Net official reserves | -1 | -1 | -56 | -270 | -105 | -138 | -50 | 60 |
| Debt service payments 8/ | 382 | 410 | 406 | 384 | 366 | 347 | 339 | 388 |
| External debt 9/ | 3,451 | 3,969 | 3,734 | 4,125 | 3,991 | 4,453 | 4,312 | 4,631 |

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

1/ Based on 1978 market prices.

2/ Colombo Index; December over December.

3/ Changes are December over December; effective rates based on IMF Information Notice System; negative change indicates depreciation.

4/ Change June 1990 over June 1989.

5/ End-December to end-December.

6/ Includes adjustments to overall deficit and financing targets for shortfalls in reconstruction expenditure and its financing as provided in the program.

7/ Excludes the foreign-financed restructuring expenditure of the bus company.

8/ Including interest payments on short-term debt and fund charges and repurchases.

9/ Including fund credit and commercial banks' foreign borrowing.

Sri Lanka: Social and Demographic Indicators

| <u>Area</u> | <u>Population</u> | <u>Density</u> |
|-------------------|---|-----------------|
| 66 thous. sq. km. | 16.6 million (1988) Rate of growth: 1.5 (1987) | 250 per sq. km. |

| <u>Population characteristics (1987)</u> | | <u>Health (1987)</u> | |
|--|----|--|-------|
| Life expectancy at birth | | Population per physician | 5,520 |
| Male | 68 | Population per nurse | 1,300 |
| Female | 73 | Babies with low birth weight (percent) | 28 |
| Infant mortality (percent) | 3 | | |

| <u>Income distribution (1980/81)</u> | | <u>Nutrition (1987)</u> | |
|--------------------------------------|----|--|-----|
| Percent of national income | | Per capita calorie supply as percent of requirements | 100 |
| Lowest 20 percent | 6 | Per capita protein intake (grams per day) | 48 |
| Middle 60 percent | 44 | | |
| Highest 20 percent | 50 | | |

| <u>Access to safe water (1981)</u> | | <u>Education (1986)</u> | |
|------------------------------------|----|---------------------------------------|-----|
| Percent of population | | Adult literacy rate (1981) (percent) | 87 |
| Total | 37 | Primary school enrollment (percent) | 103 |
| Urban | 76 | Female secondary enrollment (percent) | 66 |
| Rural | 26 | | |

Sri Lanka--Statistical Issues

1. Outstanding statistical issues

a. Real sector

Work continues on plans to replace the wholesale price index with three broad-based producer price indices, and on plans to carry out a labor force participation survey for the private sector. Although little progress has been made on both tasks since the last Article IV consultation mission, the statistical authorities expect to make greater headway by 1992.

b. Government finance

Annual data published in IFS cover consolidated central government operations through 1988, quarterly revenue data through the third quarter of 1989, quarterly expenditure and net lending data through the third quarter of 1988, and monthly revenue data through December 1989, as reported to the Bureau of Statistics by the correspondent for Government Finance Statistics. Updated annual data for 1989 have been received and are being processed.

On May 21, 1990, the Bureau received revised detailed GFS annual data for 1988, provisional data for 1989, and budgetary projections for 1990 for consolidated central government operations. However, the latest local government data pertain to 1987.

c. Balance of payments

There is a long-standing issue resulting from the inappropriate classification of Foreign Currency Banking Units as nonresidents which remains unresolved.

2. Coverage, currentness, and reporting

The table below shows the currentness and coverage of data published in the country page for Sri Lanka in the September 1990 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Central Bank of Sri Lanka which, during the past year, have been provided on a timely basis.

Status of IFS Data

| | | <u>Latest Data in September 1990 IFS</u> |
|--------------------|---------------------------------|--|
| Real Sector | - National accounts | 1988 |
| | - Prices: WPI | December 1989 |
| | CPI | March 1990 |
| | Domestic goods | Q4 1987 |
| | Import goods | Q4 1987 |
| | - Production | n.a. |
| | - Employment | n.a. |
| | - Earnings | February 1990 |
| Government finance | - Dericit/surplus | Q3 1988 |
| | - Financing | 1988 |
| | - Debt | January 1989 |
| Monetary accounts | - Monetary authorities | January 1990 |
| | - Deposit money banks | January 1990 |
| | - Other banking institutions | January 1990 |
| Interest rates | - Discount rate | December 1989 |
| | - Bank deposit/lending rates | December 1989 |
| | - Bond yields | December 1989 |
| External sector | - Merchandise trade: | |
| | Values | December 1989 |
| | Volumes | 1988 |
| | Prices | 1988 ^{1/} |
| | - Balance of payments | Q4 1988 |
| | - International reserves | July 1990 |
| | - Exchange rates | July 1990 |

3. Coverage, currentness, and reporting of data in GFS Yearbook

a. Most recent year with data: 1988.

4. Technical assistance missions in statistics (1987-present)

| <u>Subject</u> | <u>Staff Member</u> | <u>Date</u> |
|----------------|----------------------|---------------|
| Nonfinancial | P. Gschwindt de Gyor | December 1985 |
| public | | June 1986 |
| enterprises | | July 1987 |
| | | April 1988 |

^{1/} Tea and rubber wholesale prices through December 1989.

Sri Lanka: Structural Adjustment Facility:
Third Annual Arrangement

Attached hereto is a letter, with an annexed Memorandum on Economic and Financial Policies, dated September 20, 1990, from the Government of Sri Lanka, requesting from the Fund the third annual arrangement under the structural adjustment facility, and setting forth the objectives and policies of the program to be supported by the third annual arrangement.

To support these objectives and policies, the International Monetary Fund grants the requested arrangement in accordance with the following provisions and subject to the regulations for the administration of the structural adjustment facility.

1. The third loan in the amount equivalent to SDR 44.62 million is available for disbursement at the request of Sri Lanka.
2. The Fund will appraise the progress of Sri Lanka in implementing the policies and reaching the objectives of the program supported by the third annual arrangement, taking into account primarily:
 - (a) the indicators referred to in Tables 1 and 2 attached to the memorandum annexed to the attached letter.
 - (b) imposition or identification of restrictions on payments and transfers for current international transactions;
 - (c) introduction or modification of multiple currency practices;
 - (d) conclusion of bilateral payments agreements that are inconsistent with Article VIII; and
 - (e) imposition or intensification of import restrictions for balance of payments reasons.
3. In accordance with paragraph 6 of the attached letter, Sri Lanka will provide the Fund with such information as the Fund requests in connection with Sri Lanka's progress in implementing the policies and reaching the objectives supported by the third annual arrangement.
4. In accordance with paragraph 7 of the attached letter, Sri Lanka will consult the Managing Director on the adoption of any measures that may be appropriate, at the initiative of the Government or whenever the Managing Director requests consultation because of

deviations from any of the indicators referred to in Tables 1 and 2 attached to the Memorandum on Economic and Financial Policies, or because he considers that consultation on the program is desirable. These consultations may include correspondence and visits of officials of the Fund to Sri Lanka or of representatives of Sri Lanka to the Fund.

Colombo, Sri Lanka

September 20, 1990

Dear Mr. Camdessus,

1. Since the beginning of 1988, the Government of Sri Lanka has been pursuing an adjustment program supported by the Fund's structural adjustment facility (SAF). Although the performance during the first year of the arrangement was hampered by the escalation of terrorist activities and political uncertainties, the Government pressed forth its efforts in structural reform and economic stabilization and adopted the second-year economic program under the SAF. In response to tight fiscal measures and prudent monetary policy, Sri Lanka's economic performance has improved markedly since late 1989. All quantitative benchmarks and most structural benchmarks established under the second-year program have been observed.

2. The Government of Sri Lanka intends to consolidate recent economic gains and to continue to revitalize the economy. At the same time, we recognize the urgent need to focus immediate attention on controlling inflation while improving the capacity of the economy to withstand adverse external developments such as those witnessed in recent months.

3. On behalf of the Government of Sri Lanka, we are pleased to transmit herewith a policy framework paper for the period 1990-93 prepared in collaboration with the staffs of the International Monetary Fund and the World Bank. The paper describes the objectives of a three-year medium-term program; the priorities and the broad thrust of macro-economic and structural adjustment policies, and the likely external financing requirements, together with the available sources of such financing. The Government of Sri Lanka will remain in close contact with the staffs of the Fund and the World Bank on developments and progress in implementing these policies.

4. To facilitate a wider distribution of the policy framework paper within the donor community, the Government of Sri Lanka authorizes you, at your discretion, to transmit the document to any international organization providing assistance to developing countries that requests it for the exclusive use of that organization and to donor countries in the context of the forthcoming Aid Group meeting.

5. There is also attached a memorandum on economic and financial policies, pursuant to the policy framework paper described in paragraph 3 above. The memorandum sets out the objectives and policies that the Government of Sri Lanka intends to pursue during the period from

October 1, 1990 to September 30, 1991. In support of these objectives and policies, Sri Lanka hereby requests from the Fund the third annual arrangement under the structural adjustment facility.

6. Sri Lanka will provide the Fund with such information as the Fund requests in connection with the progress of Sri Lanka in implementing the policies and achieving the objectives of the program.

7. The Government believes that the policies set forth in the attached memorandum on economic and financial policies are adequate to achieve the objectives of its program but will take any further measures that may become appropriate for this purpose. Sri Lanka will consult the Managing Director of the Fund on the adoption of any measures that may be appropriate at the initiative of the Government of Sri Lanka or whenever the Managing Director requests such consultation.

Very truly yours,

Sgd.

Dr. H.N.S. Karunatilake
Governor
Central Bank of Sri Lanka

Sgd.

R. Paskaralingam
Secretary
Ministry of Finance

Attachments: (I) Policy Framework Paper, 1990-93
(II) Memorandum on Economic and Financial Policies
for 1990-91

Mr. Michel Camdessus
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431
U.S.A.

Sri Lanka: Memorandum on Economic and
Financial Policies for 1990-91

1. In early 1988, Sri Lanka embarked upon a medium-term economic adjustment program that was supported by a three-year arrangement under the Fund's structural adjustment facility (SAF). The performance during the first annual arrangement was weak. While several structural measures were undertaken to lay the foundation for improved growth and efficiency, the macroeconomic situation deteriorated, in part, owing to the escalation of civil disturbances. Against this background, in mid-1989, the Government introduced vigorous policies to stabilize the economy and adopted an economic program for the period 1989-90 that was supported by the second annual arrangement under the SAF. Under the program, fiscal policy was tightened substantially, supported by prudent monetary policies, in order to contain inflation and strengthen the balance of payments and external reserve positions.

2. In response to policy measures, a better political climate, and favorable export prices and climatic conditions, Sri Lanka's economic performance in 1989 improved substantially and in many respects was much better than envisaged in the second year program under the SAF. Considerable cuts in government expenditure and improved revenue performance contributed to a decline in the budget deficit for 1989 by nearly 5 percent of GDP to 11 percent, compared with the 12 1/2 percent program target. This, together with vigorous efforts to expand treasury bill sales to the nonbank market--in part through an active interest rate policy, resulted in a significant net repayment of government debt to the banking system. Credit expansion in other sectors was considerably below projections. As a result, all program benchmarks for December 1989 were met with large margins.

3. The current account deficit was contained to about 8 percent of GDP, compared with a 10 percent target under the program. The tight financial policies, a sizable devaluation of the Sri Lankan rupee, favorable export prices, and export promotion measures combined with a better business climate, contributed to an expansion of both traditional and nontraditional exports, a containment of imports, and a surge in capital inflows during the last quarter of 1989. The overall balance of payments deficit was also much lower than had been anticipated. The gross official reserves rebounded sharply from the precarious position at end-August 1989, when the reserves had fallen to a level equivalent to three weeks of imports and were supported largely by short-term borrowing by the Central Bank. By end-1989, the reserves had risen to 1.5 months of imports. Gross official reserves continued to build up during the first half of 1990, and short-term external borrowing by the Central Bank from the previous year was fully repaid by March. Export

performance continued strong during the first half of the year, facilitated by some improvement in the terms of trade, while imports of machinery and equipment also increased.

4. The real GDP growth rate in 1989 was 2.3 percent, slightly higher than envisaged under the program, though still below that in the previous year. GDP growth in 1990 is expected to reach almost 5 percent, slightly lower than appeared possible prior to the deterioration of the external economic environment, but substantially higher than the 3 percent growth envisaged earlier. However, inflation remains a serious problem, having accelerated toward end-1989 and in the first half of 1990, during which several administered prices were adjusted. Although the average inflation for 1989 was about 12 percent, the point-to-point increase in the rate had accelerated toward year-end and reached 24 percent in July 1990.

5. It is our intention to consolidate recent stabilization gains and to continue to revitalize the economy, to reduce price pressures, and improve the capacity of the balance of payments to withstand adverse external developments such as those precipitated by events in the Middle East in recent months. Toward these objectives, we have updated the structural adjustment program, outlined in the accompanying policy framework paper (PFP) covering the period 1990-93, which was prepared in collaboration with the staffs of the International Monetary Fund and the World Bank. Financial policies will remain tight, and interest and exchange rate policies will be monitored closely throughout this period. Efficiency in production and equitable distribution remain the primary objectives of the structural adjustment. These are to be attained mainly through enhancing private sector activity with appropriate incentives, reducing the scope of the public sector, and sharpening the focus of poverty alleviation programs. Thus, the structural measures concentrate on reforms of public administration, the public enterprises, the financial sector, and poverty relief programs.

6. The main quantitative economic targets for 1990-91 are to: (i) achieve a real GDP growth rate of around 5 percent; (ii) reduce the 1990 year-end inflation rate to 16.5 percent, thereby restraining the average rate to 21 percent, and lower the rate of inflation to 10 percent by the end of 1991; and (iii) contain the current account deficit to about 8 percent of GDP in 1990 and reduce it to about 7 percent in 1991. Toward these ends, the authorities will pursue appropriate financial policies, responding to unanticipated contingencies--such as recent events in the Middle East--to ensure that the targets are realized, and continue implementation of structural measures. As in 1989, stabilization measures during 1990-91 will focus on the central government budget, in particular on restraining public expenditure programs. In the area of revenue, measures will be directed toward expanding the tax base and increasing tax elasticity.

7. The 1990 central government budget aims at limiting the overall deficit before grants to 11 percent of GDP. The ratio incorporates the impact of higher than budgeted expenditures owing partly to exceptional circumstances, and some new revenue measures. The target is slightly higher than the 10.4 percent envisaged under the program supported by the second SAF arrangement, as additional recurrent expenditures arising from the restructuring of the Central Transport Board (CTB), equivalent to about 1/2 percent of GDP and matched by foreign financing, will also be undertaken. The net domestic financing of the budget will be equivalent to 3 1/2 percent of GDP compared with 6 percent in 1989. The Government plans to expand the sales of treasury bills to the nonbank sector, thus minimizing budgetary recourse to the banking system. The fiscal program assumes that higher expenditure owing to the oil price increase and any loss of revenue from tea exports will be offset by higher revenue from taxes on petroleum products; if necessary, compensating measures will be taken to ensure that the fiscal targets for 1990 and 1991 are not jeopardized.

8. The 1990 revenue is now targeted at around 20 percent of GDP. Although several measures originally planned for the 1990 budget--including the introduction of excise taxes on additional products and the discontinuation of extension of tax concessions to promoted enterprises after their initial expiration--were dropped, several discretionary revenue measures were adopted. These included higher excises on tobacco and liquor (with revenue impact of about SL Rs 1.1 billion); increased business turnover tax on certain nonessential items (SL Rs 0.9 billion); collection of tax arrears (SL Rs 0.8 billion); and increased taxes on companies, wealth, selected imports and higher fees and charges (SL Rs 0.4 billion).

9. Total expenditure and net lending in 1990 is expected to decline in relation to GDP, from 33 percent in 1989 to 31 percent. This estimate includes supplementary expenditure appropriations of SL Rs 7.7 billion for current expenditure and SL Rs 2.7 billion for capital expenditure, partly through onlending to public corporations. Prompted by the recently deteriorating security situation in the North and the East, additional defense spending of SL Rs 4.5 billion was approved, raising its ratio to GDP from about 3 1/2 percent to 5 percent. The supplementary expenditures are programmed to be financed by larger revenue, foreign loans, and nonbank borrowing.

10. Current expenditure accounts for 72 percent of total expenditure. This includes SL Rs 2.3 billion for severance payments to 2,800 retrenched employees of the five central departments and 10,000 employees of the CTB in the context of the privatization of the bus company. Excluding these requirements, current expenditure will decline from about 23 percent of GDP in 1989 to less than 22 percent in 1990. The increase in the wage bill has been contained to only that arising from wage adjustments for low-income employees. Capital expenditures,

including net lending, are now targeted at around 9 percent of GDP, about 1 percentage point lower than in 1989. Expenditure on the reconstruction program will amount to only SL Rs 0.4 billion, compared with SL Rs 1.7 billion envisaged in the budget, owing to the security situation.

11. In the aggregate, current subsidies and transfers in relation to GDP are expected to fall from the 1989 level but their composition in 1990 will shift somewhat in favor of direct transfers to households through the poverty alleviation (Jana Saviya), food stamp, and mid-day meal programs. Fertilizer subsidies were eliminated at end-1989, rice subsidies at end-March 1990, and wheat subsidies at end-May 1990; the Government intends to deregulate completely the prices of these commodities by end-1990, and thereafter will not allow the re-emergence of any form of subsidization. Petroleum prices have been kept under review to ensure that the petroleum corporation will incur no losses; in August 1990 prices were increased by 25 percent in response to the rising world prices, and will be increased further, if necessary, to ensure the full pass-through to the consumer. Transport and utility rates were also raised substantially, including: (i) electricity rates in April 1990, by 40 percent; (ii) all bus fares and rail fares by 40 percent in August 1990 following the 25-50 percent increase in private bus fares in late 1989; and (iii) telecommunication and postal tariffs in January 1990, by 10 percent and over 30 percent, respectively. The adverse impact on the poor of the elimination of subsidies on essential commodities will be partly mitigated through improved targeting of the above-mentioned household transfer programs, for which total costs will now be limited to 2.5 percent of GDP.

12. The Government is currently in the process of formulating the 1991 budget. Quantitative targets have not been precisely determined, but the aim is to reduce the central government budget deficit, before grants, to around 9 percent of GDP. Net domestic financing of the deficit will be reduced, with sizable net repayments by the Government to the banking system. Because of uncertainty involved, the target does not include any additional expenditure that may be justified by the completion of the privatization of the CTB and the restructuring of public manufacturing enterprises, both of which are to be supported by the World Bank (paragraphs 16 and 20-21). It is expected that due consideration will be given to the implementation of these measures in assessing fiscal performance in terms of the targeted overall deficit, and in light of other financial objectives.

13. Revenue in 1991 is expected to remain at about 20 percent of GDP. The devolution of some taxes to Provincial Councils (PCs) will reduce revenue by about SL Rs 2.5 billion (0.8 percent of GDP), but this will have no impact on the overall deficit as a corresponding downward adjustment in block grants to the PCs will also lower total expenditure. Implementation of recommendations of the Taxation Commission is

expected to lead to a net loss of about SL Rs 1.0 billion in total revenue; notable are investment relief to new companies for selected products (potential loss of SL Rs 0.5 billion), and the lowering of the maximum tariff rate from 60 percent to 50 percent (SL Rs 0.5 billion), although this will be partially offset by the implementation of excise taxes on additional products and the withdrawal of tax holidays to existing enterprises. Moreover, the Government will review tax concessions with a view to rationalizing their use which, besides reducing revenue collection, has a potential for distorting production incentives. In particular, income tax holidays will no longer be extended after their initial expiration. A review of existing legislation in light of the Tax Commission's recommendations will be conducted in the context of the 1991 budget formulation, in consultation with the Fund staff, with an objective of preserving revenue effort. Over the medium term, full implementation of recommendations by the Tax Commission is expected to broaden the tax base, improve its elasticity, reduce its regressivity, and simplify its structure.

14. Tax collection in 1991 will also gain from strengthened revenue administration, specifically, a simplification of the presently complex system and the implementation of measures initially directed at largest payers of income and business turnover taxes, which are being developed under Fund technical assistance. By April 1991, a special unit will be established for controlling the selected group of taxpayers and implementing measures to improve the penalty and appeals system.

15. In line with the Presidential Tariff Commission's recommendation, a four-band tariff system of 10, 20, 35, and 50 percent for nonagricultural products will gradually be introduced. In the 1991 budget, the maximum tariff rate will be reduced from 60 percent to 50 percent; the current 5 percent surcharge, which effectively increases the minimum tariff rate from 5 percent to 10 percent, will be converted to the lower band of 10 percent; and the remaining tariff structure will be maintained. The Government plans to complete the rationalization process and conversion to the new four-band system by end-1991, so that the system can be introduced in the 1992 budget. The tariff reform has been delayed because of the deferral of the revision of the new excise law needed to offset a part of the revenue loss from the adjustment in tariffs. In addition, specific duties--presently applied to a number of products and effectively raising the tariff rates--are due to be lowered in line with the planned reduction of the 50 percent maximum tariff rate. However, in order to deal with the problem of dumping and/or underinvoicing, minimum specific unit rates will be maintained for certain items, as well as for some agricultural products. Licensing requirements for imports of selected plastic products were lifted with effect from January 1990. A review of the few remaining import licensing restrictions, currently imposed in order to circumvent abuses in customs administration, will be conducted in the context of the ongoing

review of the administration. By end-1990, restrictions on nonagricultural products that cannot be justified by health or security reasons will be removed.

16. Total expenditures and net lending for 1991 are targeted to decline in relation to GDP, to 29 percent--representing only an 8 percent increase from 1990. Of this total, 69 percent constitute current expenditures (a 3 percent increase). This reflects an increase in interest payments on domestic debt of 8 percent. To achieve this expenditure level, the freeze on hiring except for a few essential posts will continue, and posts that have remained vacant for the past two years will be eliminated. Moreover, the increase in the civil servants' wage bill will be kept to within 9 percent. No budgetary subsidies will be given to offset below-cost pricing of food, petroleum products, and public utilities. Bus fares will be completely deregulated by December 1990, when the privatization process of the CTB is completed; already bus fares have been adjusted sufficiently to eliminate subsidies to the Central Transport Board except those for school children and uneconomic routes. Household transfers through the three major welfare programs--Jana Saviya (JSP), foodstamps, and mid-day meals--will not exceed 3 percent of GDP. The Government has requested assistance from the World Bank to help design a poverty alleviation program that could be sustained over the longer run, with the JSP being transformed to a more production-oriented program; the new approach is expected to be implemented in the second half of 1991. Railway fares have been adjusted in August 1990, with the effect of reducing the subsidy to this sector to about one third of the SL Rs 500 million provided in the 1990 budget. Defense expenditure is expected to be reduced from the unusually high level in 1990 to about 4 percent; the Government will closely monitor the need for such expenditure and, if circumstances permit, further reduce its size.

17. Capital expenditures inclusive of net lending are targeted at 9 percent of GDP (a 19 percent increase). With an expected normalization of the situation in the North and the East, where physical infrastructures have not been maintained for several years, high priority will be accorded to the reconstruction program. In consultation with the World Bank, the Government will identify for the 1991 budget a core program of adequately funded projects with high economic returns, and provide for maintenance programs, particularly for health, education, and roads.

18. The effectiveness of the current system for monitoring and controlling expenditure is expected to be strengthened by the decision to bring account officers from various central ministries under the jurisdiction of the Treasury. Measures that have been introduced in 1989 to strengthen the procedures for expenditure monitoring and control will continue to be in effect, including a monthly reporting system on cash outlays and commitments; the monitoring of budget developments by the Budget Review Committee using this system; curtailment of the use of

advance accounts; and strict enforcement of the requirement that any expenditure based on unspent appropriations from the previous budgetary year needs Cabinet approval.

19. Public administration reform is in progress. In the first round of the retrenchment plan, about 15,000-20,000 civil servants are expected to leave the central service during 1990, most through natural attrition. During 1991, 20,000 more employees are expected to be retrenched. Beginning in the 1990 budget, numerous administrative functions accounting for about one-third of the central government's noninterest, nondefense current expenditure have been transferred to the newly established Provincial Councils (PCs). Following the Salaries and Cadres Commission's (SCC) recommendation, the Government will make sure that the staffing of the PCs does not jeopardize the objective of reducing the overall size of the public service. More generally, a system has been established to monitor the PCs' expenditure under the various block grants now made by the central government.

20. Public enterprise restructuring is being tackled in several areas. In addition to privatizing the Central Transport Board's bus operations, privatization and restructuring options for the state-owned tree crop estates are being examined with the objective of improving the sector's productivity, through decentralization of management, thereby increasing its autonomy and accountability. By end-1990, an action plan will be agreed with the World Bank based on these options. The Government has already converted the Telecommunication Department into a public liability company with the objective of improving efficiency. Deregulation of shipping on most routes was effected in December 1989, and will be extended to remaining routes by end-1990, requiring at the same time a restructuring of the Ceylon Shipping Corporation.

21. The restructuring of public manufacturing enterprises (PMEs) is in progress, with technical and financial support from the World Bank, the Asian Development Bank (AsDB) and the USAID. The Government has already sold two companies--United Motors Ltd. and Thulhiriya Textiles. A Public Investment Management Board (PIMB) was established in July 1989, which, together with the Ministry of Industries, has begun the process of restructuring and divesting of PMEs. Seventeen PMEs have so far been converted to public companies. Among these, the privatization of Ceylon Oxygen Ltd., and the selling of shares of Dankotuwa Porcelain Ltd., Vayangoda Textiles, and the Hotel de Buhari held by the Treasury, is planned to be completed by end-1990. By mid-1991, four additional PMEs are planned to be commercialized, namely, the Tyres, Hardware, Leather and Plywoods Corporations, with a view to beginning the process of divesting their assets soon after. A strategy and proposals for restructuring and modernizing the cement industry and restructuring its debt are planned to be finalized by end-1990. The Government plans to divest smaller enterprises directly in the domestic capital market. A study on the sugar industry is under way, to determine

causes for the industry's need for budgetary support and to propose reforms. The study will be discussed with the World Bank to formulate, before end-1990, an action plan to restructure the industry.

22. Monetary policy in 1990-91 aims at reducing substantially domestic inflation while sustaining economic recovery and maintaining external stability. Total liquidity is targeted to expand by 16 percent in 1990 and 14 percent in 1991, compared with estimated growth of nominal GDP of 26 percent and 16 1/2 percent, respectively. The liquidity target for 1990 is somewhat higher than previously envisaged under the second SAF arrangement, as the inflationary impact of adjustments in administered prices has been greater than anticipated and money demand has already risen substantially in the first half of the year.

23. Taking into account external objectives, the increase in domestic credit of the banking system in 1990 will be limited to 13 percent, with minimal net bank credit to the Government. Demand for bank credit to public enterprises is expected to decelerate to 19 percent as various measures to strengthen their financial positions are taken. These targets will permit credit to the private sector to grow by 18 percent, sharply higher than the 5 percent expansion in 1989, a reflection of the higher level of activity and business confidence. For 1991 the expansion in domestic credit by the banking system will be limited to only 7 percent. With large foreign financing, the Government is programmed to make large net repayments to the banking system while the increase in bank credit to public enterprises is to decelerate further to 8 percent. Consequently, credit to the private sector would continue to grow at a satisfactory rate of 18 1/2 percent. These targets are expected to be adequate to assist enterprises to adjust to higher fuel costs.

24. Quarterly benchmarks for monitoring the expansion of total credit, net bank credit to the Government, and credit to public enterprises during the program period (October 1990-September 1991) are shown in Table 1. Consistent with these benchmarks for credit expansion, quarterly benchmarks for monitoring the expansion in net domestic assets of the monetary authorities are also shown. The net domestic assets of the monetary authorities will decline during this period as Central Bank net credit to the Government would need to be lowered to sterilize expected net foreign asset flows. In particular, the Central Bank intends to continue to divest its holdings of treasury bills by pursuing an active monetary policy described below.

25. The Government remains committed to achieving monetary and credit targets increasingly through the use of indirect monetary policy instruments and a more active interest rate policy. For instance, in late 1989, the Central Bank allowed interest rates to rise to 18-20 percent (on three-month to one-year maturities) as it sold its treasury bill holdings in order to absorb excess liquidity. Subsequently, interest rates at the treasury bill auctions were allowed to decline to

about 15-17 percent then raised to 17-19 percent in August 1990. On July 5, 1990, the rate on the Central Bank general advances to commercial banks (bank rate) was adjusted from 14 percent to 15 percent. The bank rate will be further increased and maintained at an appropriate rate in relation to the treasury bill rate, which will be determined based on underlying trends in the auction market. It is expected that the treasury bill rate will become positive in real terms in the latter part of the 1990: declining inflation will assist but the rate in the auction will be allowed to increase further if necessary to achieve this target. The Central Bank undertakes to review, before end-1990, the procedures for selling treasury bills with a view to making interest rates more market-determined and to implement the new system in 1991. Furthermore, the Government plans to start, at an opportune time, issuing long-term (3-10 years) securities at market rates in order to increase the range of securities in the financial market and develop further the market.

26. A more market-oriented system for indirect monetary control requires enhanced monetary policy instruments, institutional reform, and more effective banking supervision. The prospective modification of the weekly treasury bill tender is expected to develop the authorities' capacity to achieve their monetary controls and to adapt these targets promptly in response to changing circumstances. In addition, the Central Bank plans to review the refinancing facilities at preferential interest rates at the Central Bank, with a view to increasing the effectiveness of monetary control. During the remainder of 1990 and 1991, the overall level of refinancing by the Central Bank will not increase significantly from the level prevailing at end-June 1990. Reserve requirements will also be reviewed, including possible exclusion of bonds issued by the Development Finance Corporation of Ceylon (DFCC) and treasury bills. Finally, the Government will review the tax exemption on National Savings Bank (NSB) deposits and the broader role of the NSB.

27. The development of a more efficient financial system requires a strengthening of the supervisory and regulatory systems, and of the financial institutions. During 1989, measures were taken to strengthen the supervisory and regulatory role of the Central Bank in respect to the finance companies, including an introduction of a reserve requirement and accounting guidelines on loan classification. The Debt Recovery Act was introduced in December 1989, intended to expedite the debt recovery process; and a Credit Information Bureau is being set up at the Central Bank, with the participation of commercial banks and other financial institutions. Before end-1990, the Government intends to strengthen the financial system further, by introducing more rigorous loan classification and provisioning guidelines for commercial banks. The recently introduced bank capital adequacy requirement will be constantly evaluated and reformulated as appropriate. The two government-owned commercial banks have been audited. The information about the quality of their assets and solvency will form a basis for

proposals, to be prepared by June 1991, to strengthen their capital base and financial structure, with an eventual goal of their privatization.

28. The Government intends to pursue an exchange rate policy consistent with the objective of maintaining adequate foreign exchange reserves and export competitiveness. Toward this end and in order to develop an orderly interbank foreign exchange market, as well as a corresponding forward exchange market, the exchange system was modified to a market-determined regime on August 20, 1990. Under the new system, the Central Bank sets daily a reference exchange rate, which is the weighted average of the previous day's spot transactions in the local interbank market and which serves as the Central Bank's initial central rate. During the day, the Central Bank allows its own buying and selling rates in the interbank market to fluctuate--within a pre-determined band around the initial central rate--depending on its external objectives and market conditions. Buying and selling rates among commercial banks, as well as between commercial banks and their customers, are freely determined by the banks, same as in the previous system. To facilitate the new system, limits on foreign cash balances that commercial banks can hold and guidelines on banks' open positions have been relaxed considerably. Moreover, the Central Bank has ceased to provide forward cover to commercial banks, previously available in respect to essential imports. Thus, it is expected that the rate will move freely within the framework of the new system, with Central Bank intervention limited to the extent necessary to avoid excessive volatility in the market. Within this framework, the Government will ensure external competitiveness and aim at improving the official reserve position. The increase in net official reserves is aimed at no less than SDR 37 million between October 1990 and September 1991. The quarterly benchmarks on net official reserves, which are shown in Table 1, will be used as a basis for monitoring the conduct of the exchange rate policy. These targets assume that financial gaps, currently projected at SDR 46 million and SDR 115 million for 1990 and 1991, respectively, will be entirely filled, as much of the balance of payments support for restructuring the financial sector (from AsDB) and public enterprises (World Bank), currently under negotiation, will be disbursed during this period.

29. A number of other measures to promote the export sector have been taken recently, including a reform of the quota allocation system for garment exports beginning in quota year 1989/90, which allows transfers of quotas among exporters, thus better utilization of quotas. Deregulation of shipping on most routes effected in December 1989 has resulted in a 40 percent decline in freight rates. Air cargo service has been expanded, and Air Lanka's monopoly on air cargo has been removed effective July 1990. To promote investment and simplify related procedures the Government has combined the functions of the Greater Colombo Economic Commission (GCEC, in charge of the free trade zones), and the Foreign Investment Advisory Committee (FIAC). In November 1989, a 100 percent tax on transfer of equity shares between foreigners was

eliminated and in June 1990, the similar tax on transfers of equity between Sri Lankans and foreigners was removed up to a maximum foreign ownership of 40 percent (with discretionary provision for allowing larger foreign ownership). The Government is examining whether any further impediments (such as exchange control regulations and procedures) remain, with a view to their elimination. An incentive package has been extended to investment by local as well as foreign investors in specified priority areas, in particular in export-oriented businesses aimed at new products or markets.

30. The external current account deficit in 1990 is expected to be maintained at 8 percent in relation to GDP, the same level as in the previous year. In addition to requirements, imports in 1990 are expected to include extraordinary purchases for defense purposes. The projected net inflow of long-term official loans takes into account the disbursements of balance of payments financing already approved by the World Bank, the AsDB, and other donors in support of the Government's structural adjustment programs. Based on current donors' commitments, the overall balance of payments is expected to record a surplus of about SDR 9 million. Given the gross international reserves objective equivalent to 1.5 months of imports, a financing gap of about SDR 46 million is projected; the gap is expected to be filled by additional balance of payments support on concessional terms, expected to be agreed upon shortly.

31. Modest improvement in the external outlook is expected to continue in 1991, when the current account deficit is projected to decline to 7 percent of GDP. The expansion in export volume will decelerate, and the terms of trade will improve only marginally, but import growth is projected to decline sharply. Taking into account the projected net disbursements of foreign assistance from the existing pipelines, the overall balance of payments is expected to show a small deficit of about SDR 5 million. However, in view of the desire of the Government to gradually increase gross reserves to more comfortable levels a financing gap of SDR 115 million is foreseen. This gap is also expected to be filled through additional balance of payments support.

32. The program aims at progressively reducing debt service as a proportion of receipts from goods, services, and private transfers, from 21 percent in 1989 to 17-18 percent in 1990 and 1991. To this end, during the remainder of 1990 through September 1991, the nonfinancial public sector will not contract or guarantee nonconcessional loans of less than one-year maturities with the exception of normal trade financing, and will limit the accounts of newly contracted or guaranteed nonconcessional loans of maturities between 1 and 12 years to SDR 100 million. These benchmarks are shown in Table 1. The medium-term nonconcessional loans are anticipated to comprise only mixed project lending and creditor-guaranteed financing of food imports. Strict control over the commercial borrowing of public enterprises will continue.

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 give 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 | Dec. 31 | March 31 | June 30 | Sept. 30 |
| | | Est. | B'mark | B'mark | B'mark | B'mark |
| (In SL Rs billion) | | | | | | |
| Net domestic assets of the monetary authority <u>1/</u> | 25.1 | 26.0 | 26.1 | 25.4 | 25.7 | 25.2 |
| Credit from domestic banking system <u>2/</u> | 102.6 | 110.2 | 113.8 | 116.6 | 117.4 | 119.2 |
| Of which: | | | | | | |
| Net bank credit to the central government <u>2/</u> | 32.1 | 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.

Table 2. Sri Lanka: Structural Benchmarks of Policy Implementation Under the Structural Adjustment Facility, October 1990-September 1991

| | Timing |
|--|----------------|
| 1. <u>Central Government revenue and tax administration</u> | |
| a. Introduction of excise tax on selected products (paragraph 13) | 1991 Budget |
| b. Review existing tax legislation in light of Tax Commission recommendations, preserving revenue effort (paragraph 13) | 1991 Budget |
| c. Establish a unit for controlling compliance of the largest taxpayers (paragraph 14) | April 1991 |
| 2. <u>Public administration reform</u> | |
| a. Implementation of the first round of the retrenchment plan for civil servants, involving about 20,000 employees (paragraph 19) | December 1990 |
| b. Formulation and implementation of the second round of the retrenchment plan in the 1991 budget, involving another 20,000 employees (paragraph 19) | Through 1991 |
| 3. <u>Public enterprises reform</u> | |
| a. Privatization of Central Transport Board (CTB) and complete deregulation of bus fares (paragraph 16) | March 1991 |
| b. Privatization of Buhari Hotel, Ceylon Oxygen, Vayangoda Textiles, and Dankotuwa Porcelain (paragraph 21) | December 1990 |
| c. Commercialization of four additional public manufacturing enterprises, namely, Tyres, Leather, Plywood and Hardware Corporations (paragraph 21) | September 1991 |
| 4. <u>Trade liberalization</u> | |
| a. Reduction of maximum tariff rate from 60 percent to 50 percent (paragraph 15) | 1991 Budget |
| b. Preparation for the four-band tariff system, to be introduced in 1992 budget (paragraph 15) | 1991 |
| 5. <u>Financial sector reform</u> | |
| a. Introduction of revised procedure for selling treasury bills to make interest rates more market oriented (paragraph 25) | March 1991 |
| b. Introduction of more rigorous loan classification and provisioning guidelines for commercial banks (paragraph 27) | December 1990 |