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0404

November 22, 1994

Approval: 12/1/94

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 94/27

10:00 a.m., March 30, 1994

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Executive Board Attendance

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
	M. Sirat
	P. Cailleteau, Temporary
J. Bergo	
J. de Groote	
	J. Dorrington
	S. Ishida, Temporary
	T. Oya, Temporary
K. P. Geethakrishnan	L. E. N. Fernando
J. E. Ismael	
	W. C. Keller, Temporary
	R. N. A. Ally, Temporary
	E. Kouprianova, Temporary
	R. Bessone Basto, Temporary
	B. S. Newman
	M. A. Brettschneider, Temporary
	J. B. Wire, Temporary
	J. M. Burdiel, Temporary
	M. A. Ahmed, Temporary
	H. Golriz, Temporary
	B. S. Dlamini
G. A. Posthumus	
	Y.-M. T. Koissy
	J.-C. Obame, Temporary
	E. Wagenhoefer
	G. M. Blome, Temporary
A. S. Shaalan	Y. Y. Mohammed
	G. F. Murphy
	N. L. Laframboise, Temporary
	Y.-H. Lee, Temporary
Zhang M.	Wei B.
	Yang X., Temporary
A. G. Zoccali	

L. Van Houtven, Secretary and Counsellor
L. Collier, Assistant

Also Present

IBRD: P. Alba, South Asia Regional Office; E. Cohen, Africa Regional Office. African Department: E. A. Calamitsis, Deputy Director; P. A. Acquah, C. V. Callender, J. A. Clément, G. Devaux, P. Dhonte, I. A. H. Diogo, A. S. Franco, J. Harnack, E. G. Kpodar, M. Mira D'Ercole, R. H. van Til. Central Asia Department: H. Neiss, Director; P. Gotur, P. J. Heytens, Y. Horiguchi, I. Otani, M. Rose, D. Tzanninis. External Relations Department: P.-M. Falcone. Fiscal Affairs Department: M. Fouad. Legal Department: H. Cisse, Y. Elizalde, J. M. Ogoola. Policy Development and Review Department: J. T. Boorman, Director; T. Leddy, Deputy Director; J. D. Crowley, C. Puckahtikom, B. E. Rourke, A. Singh, K. Thugge. Secretary's Department: A. Mountford. Advisors to Executive Directors: J. M. Abbott, A. Chang Fong, T. K. Gaspard, A. R. Ismael, M. F. Melhem, R. Meron, J. Ortiz Vely, B. A. Sarr, A. Törnqvist, J. W. van der Kaaij. Assistants to Executive Directors: S. Al-Huseini, A. Cathcart, J. Hamilius, O. Himani, C. Imashev, T. Isataev, K. Kpetigo, T.-M. Kudiwu, J. Mafararikwa, S. C. McDougall, S. Narube, H. Petana, R. K. W. Powell, N. Prasad, S. K. Regmi, A. Viirg, R. von Kleist.

1. EXECUTIVE DIRECTOR

The Acting Chairman welcomed Mr. Newman as Alternate Executive Director for the United States.

2. GABON - 1994 ARTICLE IV CONSULTATION; STAND-BY ARRANGEMENT; AND PURCHASE TRANSACTION - COMPENSATORY AND CONTINGENCY FINANCING FACILITY - FLUCTUATIONS IN EXPORTS

The Executive Directors considered the staff report for the 1994 Article IV consultation with Gabon and Gabon's requests for a 12-month stand-by arrangement in an amount equivalent to SDR 38.6 million and for a purchase equivalent to SDR 21.5 million under the compensatory and contingency financing facility (EBS/94/57, 3/18/94; Cor. 1, 3/28/94; and Sup. 1, 3/30/94). They also had before them the authorities' letter of intent (EBS/94/37, 3/2/94) as well as a statistical annex (SM/94/73, 3/22/94).

The staff representative from the African Department made the following statement:

> Since the issuance of EBS/94/57, the staff has been informed that the Gabonese authorities have taken steps allowing a pass-through of the cost increases arising from the devaluation on consumer prices of bread--40 percent--and medicines--60 percent. Trade margins on imports remain subject to a 15 percent ceiling.
>
> The newly formed Government is expected to present shortly to the National Assembly a revised draft finance law for 1994. The revised draft states the Government's intention to limit wage increases in the public sector to 8 percent, which is in line with the program.
>
> As regards the financing of the 1994 program, the authorities have recently obtained assurances regarding a CFAF 40 billion program loan from the African Development Bank. They have also finalized Gabon's request for debt rescheduling from the Paris Club. On the assumption of a comprehensive rescheduling of all pre-cutoff arrears, including late interest, and all current maturities on pre-cutoff debt, there remains a residual financing gap of about CFAF 60 billion. To cover this gap, the authorities have requested additional bilateral exceptional assistance, and they have also been discussing a commercial bank loan on appropriate terms and conditions. On this basis, the staff believes that there will be sufficient financing to cover the residual gap.

Mr. Obame made the following statement:

At the outset, I would like to express my Gabonese authorities' appreciation to management and the staff for the invaluable assistance provided during the negotiations of the current program, in support of which they are requesting a 12-month stand-by arrangement and a drawing under the compensatory and contingency financing facility (CCFF).

Recent developments in the Gabonese economy should be assessed against the background of the continued deterioration in Gabon's terms of trade, the heavy external debt-service burden, the sharp curtailment of external financing, and the difficult transition to multiparty democracy. The combined effects of these factors caused a sharp contraction in economic activity in 1993, leading to further deterioration in the budgetary situation and a sizable buildup of internal and external payments arrears. Moreover, the overall balance of payments position remained negative.

Against this background and well aware of the need to broaden the scope of their adjustment strategy, my authorities have taken the decision to bring into play the exchange rate instrument. This measure, together with a tightening of financial policies and an acceleration of structural reforms, should help restore equilibrium in the public finances, promote external competitiveness, and achieve financial viability in the medium term.

Strengthening the public finances will be at the core of the 1994 program. On the revenue side, with the effect of the devaluation, oil revenue will increase by about 62 percent. Non-oil revenue is also expected to increase as a result of the implementation of the new customs and tariff reform in the context of the UDEAC (Union Douanière des Etats de l'Afrique Centrale--the regional customs union), the broadening of the tax base, and the valuation effect of the devaluation on international trade. On the expenditure side, my authorities have decided to limit to 8 percent the increase in the wage bill, and they will continue their efforts to streamline the payroll files and to enforce the measures regarding the retirement of civil servants. With regard to other current expenditure, enhanced controls will be applied to transfers while the new law regulating scholarships will be implemented systematically. These measures will provide some room to undertake much-needed public investment in economic infrastructure and in the health and education sectors. In addition, the authorities will make partial settlement of domestic arrears, which should help to alleviate somewhat the acute liquidity shortage in the private sector. With these revenue-raising and expenditure-containing measures in place, the overall budgetary situation is projected to improve substantially over the medium term.

Monetary and credit policies will remain restrictive with the main objective being to contain inflation and to achieve the balance of payments objectives. In this regard, net credit to the Government will be reduced and the increase in credit to the economy will not exceed 24 percent. Moreover, on January 14, 1994 the central bank raised its discount rate from 11.5 percent to 14 percent. In view of the uncertainties regarding the behavior of monetary aggregates, my authorities will continue to monitor closely monetary developments and will implement, if necessary, corrective measures.

In the external sector, the vulnerability of the economy to fluctuations in oil prices cannot be overemphasized. This is well illustrated by the sensitivity analysis presented in the staff report. The vulnerability of the external sector is further exacerbated by the heavy short-term debt burden. My authorities strongly believe that in the absence of an appropriate solution to their debt problem, the medium-term prospects will remain clouded. Such a solution should take into account the real capacity of the country to repay and the need to stimulate growth. In this context, they have approached private creditors participating in the London Club, and an agreement has already been reached with them on the restructuring of Gabon's commercial debt. My authorities have also submitted a request for debt rescheduling to the Paris Club with the expectation that a lasting solution to Gabon's external debt problem will be found. As to the remaining financing gap for 1994, my authorities have approached several potential creditors and there are strong indications that this financing gap will be covered.

Regarding structural reforms, my authorities will continue to focus their efforts on the restructuring of public enterprises. An interministerial committee on parastatals has been appointed and is in charge of assessing, on a quarterly basis, trends in financial relations between the Government and the main public enterprises. Moreover, the authorities have recently adopted, within the framework of a comprehensive reform in the UDEAC, measures aimed at further liberalizing the economy and promoting private sector activity. In particular, customs duties have been substantially reduced, and a new tariff structure comprising four rates is being applied. To promote competition within the private sector, it is the authorities' intention to eliminate in the course of this year the tax and trade privileges granted to some enterprises. Also, export taxes, except those levied on mining and forestry, will be removed. Pending the completion of the ongoing study on economic diversification, my Gabonese authorities are fostering regional integration as a means of strengthening trade and economic cooperation among UDEAC member countries. They have recently signed a treaty creating the Economic and Monetary Community in Central Africa (CEMAC).

Regarding my authorities' request for drawing under the CCFF, the staff's calculations show that the projected shortfall for 1994 is about SDR 116.9 million. As indicated in the staff report, this request is in line with the criteria set under Section II of the CCFF decision and is justified.

In conclusion, while my authorities are well aware of the uncertainties facing the economy at this critical juncture, they are confident that, with the measures already in place and their determined efforts to implement the adjustment program, these uncertainties can be considerably reduced. In this regard, they wish to stress that the current arrangement with the Fund should be considered a first step in their overall adjustment strategy. This strategy, the "nouvel élan," aims at mobilizing popular support for the efforts needed to strengthen public finances, promote private sector activities, and diversify the economic base of the country. It is my authorities' expectation that they can continue to count on the international community, and in particular on the Fund and the World Bank, to assist them in achieving these objectives.

Mr. Sirat made the following statement:

As a result of the welcome opportunity we have been given to review over a rather short period of time the situation of nearly all the member countries of the CFA franc zone, we can see that each country is neither exactly the same as the others nor completely different. Gabon is a case in point. It has, like the others, a similar problem of fiscal imbalances that has to be corrected rapidly; but its economy is distinctive because Gabon is an oil producing country where oil represents 30 percent of total GDP, and GDP per capita is significantly higher than that of its neighbors. In the short term, correcting the fiscal imbalances is the urgent task, but from a medium-term perspective, the process of growth recovery will be specific to this oil economy. The report rightly emphasizes this point.

On the revenue side, the main reform is a sharp reduction in customs duties, related to similar reforms implemented in all UDEAC countries. In addition, an expansion of the tax base and the introduction of a value-added tax are to take place during the program period.

But the bulk of the effort will be on the expenditure side. First, the wage bill will be contained, with increases limited to 10 percent in 1994. Naturally, this fiscal limitation on the wage bill will have positive consequences as regards inflation, both directly and indirectly, by sending appropriate signals to the private sector. From this point of view, I note with satisfaction that recent agreements with the unions would allow increases limited to 8 percent in the civil service and 15 percent in the private sector. Second, I welcome the "full budgeting" practice that will be implemented from 1994, allowing for greater clarification of the relationship between the Government and public enterprises. Undoubtedly, this clarification will in itself be a strong incentive to implement and accelerate reforms in the public enterprise sector.

Also, the program includes significant built-in contingency schemes--for example, the counterpart of purchases from the Fund under the stand-by arrangement will be set aside at the central bank to be used, if necessary, in case of a fall in oil prices. Similarly, the program encompasses a sharp increase in capital expenditures, according to Table 2 of the report, which apparently is linked to construction of an important road scheme and will be financed significantly by domestic resources. I presume that the authorities will have some room for maneuver within the financial framework agreed with the Fund, particularly through phasing of their investment projects. Besides, the authorities will have difficulty striking a balance between accelerating the settlement of domestic arrears and increasing public capital expenditures so as to foster growth.

As to the medium term, I was interested in the theoretical framework provided by the staff on the basis of a 1991 working paper ("Oil, National Wealth, and Current and Future Consumption Possibilities" (WP/91/60)). Clearly, the reduction in oil rent should lead to a suitable and sustainable equilibrium between consumption and investment. For a given level of oil production over a year, there would be, according to this scheme, one relevant level of investment, allowing for maintenance of national wealth. Naturally, this approach implicitly supposes that this volume of investment could generate a stream of benefits that would yield an appropriate rate of return comparable to that of oil wealth. Obviously, this is an important assumption and, in particular, it is not certain whether the large investments in public infrastructure contemplated by the authorities would respect such a constraint.

If it appeared that the volume of profitable investment was not sufficiently high, the authorities would have three theoretical choices. They could reduce oil production in the short term so as to maximize the long-term benefit from oil by adjusting production to the level of effective investments available in the country. But such an approach might be difficult to implement, particularly as it would lead to fiscal difficulties. Alternatively, the authorities could implement structural reforms so as to enhance the profitability of investments within the country. These reforms would encompass, as noted on page 5 of the staff report, the operation of public enterprises, civil service management, and labor market arrangements. Ultimately, if it appeared that, given the size of the economy, it was difficult to find suitable investments within the country, then the authorities could choose to invest the profits from the oil rent abroad, becoming a kind of rentier economy. Each choice is risky, given the great uncertainties concerning the future price of oil.

Practically speaking, the second option seems the most attractive as it would help to make the most of Gabon's natural resources and investment opportunities, which go well beyond oil resources. Such an option would also help to maintain and improve the relationship between Gabon and foreign investors, which should allow for levels of foreign direct investment higher than the conservative figures given in Table 4 of the report.

Altogether, I would concur with the staff's appraisal that, in the present circumstances, Gabon is being offered a unique opportunity to improve its growth prospects, diversify its economy, and prepare for eventual depletion of its oil resources. In the short term, I do not have too many worries as regards the level of inflation, given the past history of the zone; but I would agree with the risks listed in the staff report and, in particular, would stress the crucial need to effectively limit the wage bill in the civil service.

Mr. de Groote made the following statement:

I welcome the decision of the Gabonese authorities to significantly enhance their adjustment strategy. Although many of the comments already made in this Board on other CFA countries are of course relevant to Gabon, this country's case is somewhat different.

Indeed, the country is a major oil producer in the region. Its entire development strategy was based on the strength of the country's oil resources; in 1993, 81 percent of export proceeds were derived from oil production. The experience of Gabon since the price shock of 1986 and the failure of previous Fund-supported programs demonstrated the vulnerability of a development strategy exclusively focused on oil production.

In addition, Gabon's position as the largest oil producer in the CFA franc zone, which barely places it in the category of medium-income countries, seems to put it at somewhat of a financial disadvantage, as this has apparently dissuaded the Paris

Club from extending to Gabon the same debt alleviation concessions made for Côte d'Ivoire, Senegal, and other members of the zone. I would argue that such an exclusion is paradoxical for two reasons: first, as an oil producer, Gabon's situation may be even more fragile than that of other members of the zone, requiring at least comparable protection in the form of debt alleviation or even debt forgiveness; and second, as the development motor of its region, Gabon's success in stabilization and development is likely to have positive spillover effects on its neighbors.

The fall in world oil prices in 1986 had repercussions on the terms of trade. Chart 1 in the staff report shows the deterioration of the terms of trade and the "chasm between the terms of trade trends and those of the real effective exchange rate." However, I have some reservations concerning the conclusion that this chasm is a clear indication of a significant overvaluation of the exchange rate. Indeed, according to International Financial Statistics, by declining by 22 percent from 1985 to 1993, the real effective exchange rate has already corrected part of the terms of trade evolution. Moreover, as 1985 is taken as a reference year, it introduces a bias in the terms of trade evolution because 1985 was the year before the "reverse oil shock" of 1986. At the same time, the U.S. dollar was at its peak against the French franc. It would be interesting to assess the influence of the U.S. dollar over the evolution of the terms of trade and of the real effective exchange rate.

The recent decision to devalue the CFA franc provides a unique opportunity to reverse the declining trend in economic performance and to increase competitiveness. For Gabon particularly, it is also a chance to depart from the one-sided oil-based growth strategy and initiate a long-needed process of diversification of the economy.

As to the substance of the program, I would like to comment on its fiscal and structural aspects in relation to the major task of economic diversification. First, developing new areas of production and services in the non-oil sector will require significant improvement of the budgetary situation. The progress made by the authorities in strengthening budgetary control must be complemented by the restoration of a sufficient primary surplus resulting from an enhanced performance on both the revenue and expenditure sides. The proposed measures aimed at reforming the tax system and at increasing customs receipts are most welcome in this connection.

I also commend the authorities' position on the importance of wage restraint in the short to medium term. The 10 percent nominal growth level planned for 1994 seems both acceptable from the standpoint of fiscal stabilization and justified socially. In this context, I would like to emphasize the position of my constituency as already expressed during the discussions on Niger and Cote d'Ivoire: there is merit in the temporary price subsidy scheme for consumption goods, which should not be considered a slippage from the norms of ideal fiscal management. Allow me, however, to urge the Gabonese authorities not to delay working out the details of such a subsidization scheme, particularly details for phasing out the subsidies before they acquire a life of their own and replacing them with a system of income targeting.

Second, diversification of the Gabonese economy will require significant efforts in the area of structural reforms and privatization. I welcome the intention of the authorities to strengthen the management of public enterprises, increase their exposure to market discipline, and eliminate arrears. I remain, however, concerned about the sharp increase in imports and the low degree of import substitution, which reflect the weakness of the private sector. I realize that time constraints prevented a full description of privatization expected under the program at this stage. Could the staff representative provide some information on the authorities' medium-term intentions for privatization in Gabon? I support the proposed decisions.

Mr. Wire made the following statement:

The Gabonese authorities have stressed that the program before us should be considered a first step in their overall adjustment strategy. It is unfortunate that Gabon's economic policymakers once again find themselves back at the drawing board, and that in recent years Gabon has not taken advantage of the developmental opportunity afforded by an abundant resource base and relative wealth. As a result, the economy is less diversified, more vulnerable, and more indebted than it should be; living standards and income levels are more stratified than they ought to be; and Gabon's social and demographic indicators remain quite poor, particularly compared with other middle-income countries.

Nevertheless, participation in the recent regional decision to devalue the CFA franc, which we warmly welcome, gives Gabon another chance to extricate itself from its financial difficulties and lay the basis for a broader effort to address long-term developmental needs. To produce the desired results, devaluation must be accompanied by appropriate financial policies and progress on structural reforms, and in this connection, we would have preferred to see a somewhat more ambitious effort to ensure that the potential gains of the devaluation are fully realized.

Overall, the considerable risks to the program, starting with the fiscal and external vulnerabilities relating to oil prices, have been outlined with relative candor. The counter-balancing commitments to contingency measures constitute a critical commitment in our view. But a more ambitious effort to boost revenues and reduce nonessential spending could better ensure that economic resources are freed up and devaluation gains are passed through to the external sector.

On the assumption that the budget is submitted to Parliament and approved next month as the staff expects, tough but necessary policies have to be enforced, particularly to ensure that public sector wages evolve as expected. But a greater degree of fiscal adjustment looks like it would have been helpful to reduce the overall public sector wage bill and the fiscal burden of transfers to public enterprises. As far as priority expenditures go, the commitment to maintain health and education expenditures in real terms is welcome but should be viewed as a bare minimum in view of Gabon's still large developmental needs. Also, regularization of relations with domestic creditors seems to be moving on a less than satisfactory track, with only about 20 percent of the arrears to be cleared this year--although, like Mr. Sirat, we recognize that a delicate balance has to be struck. Finally on the expenditure side, we urge an early end to the remaining price controls or margins that are still in place.

Regarding non-oil revenues, we would urge that the export taxes on mining and forestry be turned into production-based taxes. Although it is still a minor revenue source, we could question the long-term wisdom of reducing petroleum taxes as a short-term method of containing inflation. However, on the revenue side we are generally satisfied with the planned measures, particularly relating to tax receipts and customs and import duties.

To improve budgetary control, contingency funds must be carefully monitored to ensure that funds are available for their intended purpose. In the same vein, we welcome other planned efforts to tighten budgetary procedures to reduce opportunities for abuse, improve accountability, and increase transparency, particularly on the expenditure side of the budget. In this connection, while appreciating the limited functional information the staff has provided, a fuller breakdown of expenditures would be helpful in future papers.

Looking at other aspects of the program, the authorities seem to acknowledge that oil production is sustainable at present rates for only another decade. But Gabon's development strategy needs a stronger focus on bolstering private investment and competitiveness throughout the economy. We fully share the staff's view that successful fiscal adjustment is a readily available and effective means of improving the overall investment climate. Of equal importance, greater attention to structural reform could help with the fiscal objective, promote general efficiency gains, and shift assets to more productive uses. In this connection, we agree that, of the three choices outlined by Mr. Sirat, the second choice, structural reforms, would seem to be the wisest course. Unfortunately, the apparent absence of concrete plans on a number of important structural issues leaves open the possibility that Gabon will not be able to capture these gains for some time.

For instance, public enterprises continue to play a large role in the economy, but Gabon's plans merely to restructure and monitor these enterprises seem to fall far short of the privatization effort that appears to be needed. The civil service remains bloated, with the Central Government accounting for about 40 percent of total employment in 1992, and the wage bill represents a large, although declining, claim on public finances. Civil service reform should be tackled quickly, with a higher priority given to reducing the size of the work force and improving its efficiency. As a side note, available data in the statistical appendix indicate that total salaried employment in Gabon amounts to less than 10 percent of the total population. Unless this is truly the case, statistical improvements in this area appear warranted, especially as economic data otherwise appear to be reliable.

Regarding trade policy, we commend Gabon for the steps it has taken to reduce effective protection levels, but a few quantitative restrictions on imports remain that should be removed in line with the commitment in the letter of intent.

Foreign investment, which appears to have been minimal outside the oil sector, will take its cue from domestic investment and the level of economic activity, but work to improve the transparency of the regulatory and investment framework could play an important role as well, and greater efforts should be devoted to these measures.

We also urge Gabon, as we have urged the other CFA countries, to remove the repurchase restrictions imposed this past summer and to return quickly to full convertibility. As a separate matter, we would also like to see an early move to Article VIII status.

With regard to external financing for the program, the rather cursory financing assurances leave us somewhat uneasy, as a gap of about $100 million, or 3 percent of GDP, remains to be closed, even after a comprehensive Paris Club rescheduling of pre-cutoff debt. It is not clear why these loose ends could not have been better tied down before this meeting, even if Gabon has access to commercial borrowing. Overall, we are left with the impression that domestic adjustment has been treated as a residual in the calculations. The financing assurances provided yesterday were helpful in clarifying language in the staff report that could have been interpreted as suggesting that Gabon was seeking a deferral of post-cutoff date arrears beyond the consolidation period of a Paris Club rescheduling, an assumption that my authorities viewed as unrealistic, at best.

With regard to external assistance generally, much is riding on this program. Full and timely implementation of the various commitments that have been made will be important to erase the blemishes on Gabon's economic record and to provide donors and creditors with a continued basis for supporting the adjustment effort. On a broader front, we hope that this program marks the beginning of a sustained effort to harness for Gabon's long-term gain the combined advantages of resources, relative wealth, and enhanced competitiveness that the country now possesses.

Mrs. Wagenhoefer made the following statement:

It is especially disheartening to observe that even a country with a--relative to its size--huge export-earnings-generating oil sector is mired in such deep trouble as Gabon. We could ask: "Where have all the dollars gone?"

While we share the staff's view that the buildup of domestic and external payments arrears is worrisome, we feel that the current level of oil prices should be described not as a "trough" but as a normalization following the rise in oil prices in 1990 and 1991 effected by the Gulf war. The potential additional oil supply from some countries of the former Soviet Union and Iraq, and possibly from new producers such as China, would make it seem improbable that oil prices will once again move upward significantly. The staff has indicated that contingency measures for this scenario have been discussed.

As the oil sector, therefore, does not appear to be that promising, the authorities should concentrate on creating an environment in which non-oil private investment can flourish. It is questionable in this context whether the improvement in competitiveness, which undoubtedly has occurred with the long-overdue devaluation of the CFA franc, should be measured through relative consumer prices. As the development of wage costs seems to be the Achilles' heel of the program, it might be appropriate to measure competitiveness through wage costs in the tradable sector. This difference is especially important for a country with a history of price stability and strongly growing wages. Perhaps the staff could comment.

On regional trade, I note that while Gabon is a member of the Central African Economic and Monetary Community, it has traded, during the past three years, only 0.1 percent of its total exports with other UDEAC members and about 3 percent of total imports during the same period. It does not make sense to, on the one hand, suffer the inflexibility of a monetary union and, on the other, conduct virtually no trade with other members of that union. We believe that this failure to open markets to regional trade in Africa is an important reason for the economic difficulties on that continent. "Trade not aid" remains a true principle --also when applied to South-South relations.

Let me add that Executive Directors should focus on the specific tasks of the Board and should not interfere with or prejudice in any way the responsibilities of other forums, notably the Paris Club. This applies to several aspects of the Paris Club's work, including the classification of debtor countries according to their level of income and the specific forms of debt rescheduling decided by the Paris Club.

Mr. Ishida made the following statement:

Gabon has significant export-earning resources, notably oil, and its external position should be much stronger than that of other CFA franc countries. However, since the late 1980s the country has been facing financial difficulties that have not been resolved so far. Needless to say, the difficulties have been largely due to sluggish oil prices in recent years. However, they were also caused by excessively heavy external borrowing during the 1980s and by the authorities' failure to make effective use of the borrowed funds for the necessary diversification of industry. The authorities are encouraged to draw a lesson from this experience.

For successful diversification, the following policies are required. First, to increase investment in the non-oil sector, the fiscal position should be consolidated sufficiently and domestic savings should be increased, because excessive dependence on external borrowing needs to be avoided. Second, it is essential that the limited funds be allocated only to projects from which a high rate of return can be expected. Third, based on the current foreign exchange regime, domestic producer costs should not be allowed to increase over the medium term.

On the fiscal front, we see from the letter of intent that a limited increase in the wage bill is a key item of fiscal policy for 1994. While the sharp increase in revenue associated with the devaluation--for example, from the increase in customs duty--is a one-time occurrence this year only, strong pressure to increase the wage bill is expected to continue for several years. Consequently, the authorities should commit themselves to resisting the pressure over the medium term.

As the staff reports, there is a conceivable risk of a large reduction in customs duty and oil revenue. The authorities are urged to monitor actual tax collection closely, and if revenue falls short of target, they should reduce expenditure and/or adopt additional measures to increase revenue in order to achieve the objective of fiscal balance.

The authorities are moving in the right direction with regard to the policy of reducing current expenditure and increasing government investment. However, because inflation in 1994 is expected to be about 30 percent, I am concerned that an 80 percent increase in investment is so high that it might accelerate inflation. In addition, could the staff identify the sectors in which the authorities intend to invest.

On structural reform, as I said earlier, to achieve diversification and strengthen external competitiveness, domestic producer costs should not be allowed to increase over the medium term; however, I believe that the price controls imposed by the authorities will not be effective over the medium term. I commend the authorities for their intention to liberalize the labor market. Nonetheless, I am worried that public enterprise reform is not ambitious enough, and I encourage the authorities to make further efforts to improve the efficiency of public enterprises, including by privatization.

With regard to the external sector, I can agree with the staff's emphasis in its report on the risks to Gabon's external position related to changes in oil prices. However, in view of the huge external debt, the authorities also need to pay close attention to another risk, related to an increase in the international interest rate. The authorities should be fully aware that while global economic recovery will increase the price of oil, at the same time the recovery will, in general, pump up world interest rates. With these comments, I support the proposed decisions.

Mr. de Groote observed that Executive Board discussion of the implications of Paris Club developments was warranted in light of the obvious interaction between Paris Club decisions and the Board's work. Recently, a country matter had had to be removed from the agenda when it was concluded that resources were not available to cover the financing needs of the country. The Fund did not finance country programs alone: the programs were predicated on contributions from other sources in the form of debt alleviation or restructuring. Therefore, recent experience led him to argue for even closer contact between the Paris Club and the Fund so that management could confidently propose to the Board programs that could be implemented because they had sufficient financing.

Mrs. Wagenhoefer considered that in several summings up there had been undue emphasis on the Board's views regarding the specific form that rescheduling for a country should take. The Board should leave such decisions--as well as, for instance, the classification of countries according to income levels--to the Paris Club.

Mr. de Groote remarked that when there was uncertainty about the financial resources that a country would have at its disposal, additional measures had to be undertaken. Fund-supported programs were predicated on the availability of a certain amount of resources, as defined and determined by the modalities of the debt rescheduling or alleviation exercise.

The staff representative from the African Department said that the authorities' plans for privatization of public enterprises were part of their work program over the coming year in preparation for a possible program to be supported by an extended arrangement.

The staff's assumptions for oil prices had been based on the continuing decline in the terms of trade over the past few years--as shown in Chart 1 of the staff report--despite a short-lived price increase in 1991, the staff representative remarked. As regards the forecast for a moderate recovery of oil prices over the medium term, the staff relied on the assumptions and scenarios underlying the World Economic Outlook. Incidentally, those assumptions of recovery for 1995 and beyond from the current trough were shared by the oil sector in Gabon.

Mrs. Wagenhoefer commented that Financial Times of the previous day had included a chart that showed the different results obtained in forecasting a recovery in oil prices, depending on the base year used--say, comparing current oil prices with those in 1984-85 as opposed to those in 1986. The statistical problem was significant and reinforced the value of looking at prospects from various angles.

Mr. Al-Jasser remarked that Mrs. Wagenhoefer appeared to hold the view that 1986 oil prices were the norm, that any subsequent changes were aberrations, and that consequently a normalization--rather than a trough--was in place. But, looking at oil prices over the longer term, he considered that current levels represented a depression rather than a normalization. Observers of oil prices in the industry would agree that the prices in 1986 constituted a serious decline rather than the norm.

The staff representative from the African Department said that, for Gabon, oil prices had two dimensions. In the short term, the staff had to determine whether there was a trough--mainly a statistical issue--and if it was sufficiently deep to be compensable under the CCFF. In the medium term, the assumptions for oil prices constituted a major policy issue, affecting the authorities' decisions on investments and fiscal targets. While to the extent possible forecasts were based on World Economic Outlook assumptions, admittedly the figures could be revised sharply from one month to the next.

On competitiveness indicators, ideally a relative unit labor cost measure would be preferable to a relative consumer price index, but the latter had gained currency because it was the most readily available indicator, and in a number of countries the only available indicator, the staff representative noted. The staff had looked into the use of another measure--the share of wages in value added--which would indicate the domestic terms of trade; it revealed a sharp improvement in the export sector and some improvement in the domestic sector.

The investment program was heavily focused on the development of road infrastructure, which undoubtedly could be efficient from a long-term developmental perspective, the staff representative from the African Department noted. The staff had emphasized the need for caution and to proceed only with projects that had a certified high rate of return, in view of the high level of risk involved.

Mr. Dlamini made the following statement:

> This discussion is taking place at a time when Gabon's economy is facing serious difficulties, mainly as a result of terms of trade losses and the impact of heavy external debt obligations. The recent exchange rate adjustment and the request for a Fund-supported program are bold initiatives intended to bring about a fundamental shift in policy, with the aim of restoring macroeconomic stability and bringing about sustainable economic growth.
>
> The program rightly emphasizes fiscal consolidation, the enhancement of efficiency through structural changes, and the diversification of the export base away from the current heavy dependence on oil. I urge the authorities to persevere in the implementation of the program, because it provides an opportunity for Gabon to address its economic difficulties and mobilize the necessary donor support.
>
> As I am in broad agreement with the thrust of the staff report and its recommendations, I will comment only on a few aspects of the program. The price freeze and cuts in customs duty and other tax rates are being used to counter pressures from the civil service. While we support this policy as a temporary measure, we urge the authorities to watch against compromising revenue objectives, given that the estimates on import volumes are only tentative. The authorities should move quickly to implement measures that would sustain a prudent wage policy in the medium term. At the same time, we welcome their intention to introduce a value-added tax and eliminate tax exemptions during the course of 1994, which would help to reduce the heavy reliance on oil revenues.

There is no doubt that export diversification is at the heart of Gabon's long-term economic viability. In this connection, the elimination of export taxes and nontariff barriers are important steps. The Government's efforts aimed at promoting private investment in nontraditional export ventures would also be crucial. Meanwhile, given the heavy debt burden of the country, it seems that concessional debt relief should be an integral part of the strategy to improve Gabon's prospects for external viability. Like Mr. Obame, we urge the international community, and in particular the Fund and the World Bank, to assist the Gabonese authorities in achieving their objectives.

Mr. Keller made the following statement:

Gabon appears to have been taken by surprise by the CFA franc zone's common decision to change the franc's parity. Declarations made by its authorities in the aftermath seem only to confirm the impression of their rather hesitant commitment. Accordingly, the proposed program seems to aim foremost at limiting the consequences of the devaluation as well as regularizing the internal and external financial situation. We support the proposed decisions and welcome in particular the appropriate built-in contingency based on petroleum receipts. However, a number of important issues remain in respect of stabilization measures, particularly structural reforms.

With regard to fiscal policy, and considering the strained state of public finances and the ambitious target of primary surpluses, first, we welcome the agreement between the staff and the Gabonese authorities on an enhanced set of prudent principles for transparent and sustainable budgeting, and we strongly encourage the authorities to adhere scrupulously to those principles. Second, it would be useful to have more specific fiscal targets, on both the revenue and expenditure sides, instead of qualitative intentions, but we understand that the staff will closely monitor developments, including with respect to a steady decrease of domestic arrears. Third, the Government's intention not to raise domestic petroleum prices may not constitute a subsidy, but it still represents a substantial reduction of fiscal revenue from this source. Finally, while welcoming the reduction in import tariffs and increased trade liberalization in principle, we invite the staff to comment on the introduction of import tariff rates that are lower than agreed within the UDEAC and that are compensated by higher export tariffs. Is the rationale behind this shift in revenue sources a desire to counteract the import-demand-reducing effects of the devaluation?

With regard to savings and investment, Gabon, unlike other CFA countries, has traditionally enjoyed relatively large domestic savings. But perhaps the extremely high domestic costs resulting from significant import penetration and high unit labor costs will not be reduced enough by the devaluation to strengthen domestic competitiveness and thus significantly improve private investment prospects in the non-oil economy. Unless far-reaching structural reforms are adopted and implemented, the supply response will probably be modest and investment opportunities will remain scarce. However, there remains considerable scope to reduce import penetration, particularly of food imports, if existing distortions of relative prices are effectively reduced.

In the past, excess domestic savings did not all flow into domestic investment. They, including public funds, were to a substantial extent transferred abroad, representing a heavy drain on the capital balance, while Gabon was accruing domestic and foreign payments arrears. Thus, I ask: "Why have all the dollars gone?" Perversely, some outflows were replaced by foreign capital, which was not directed only to the oil sector. Still, could the staff comment on why Gabon does not have larger foreign assets and why it is not earning more current capital income?

With regard to the balance of payments, the program is expected to help re-establish orderly relations with foreign creditors. Confidence is certainly essential at a time of uncertain prospects for an early upswing in oil prices. To assess the long-term perspective for the extraordinary efforts required by the creditors, it is essential to observe the pattern of domestic and foreign capital flows. Does the staff have any early indications of capital repatriation? If it is correct that some commercial banks are awash with liquidity--which incidentally helps to strengthen their balance sheets--how are these funds going to be invested consistent with the restricting performance criteria under the stand-by arrangement?

To conclude, we must underline that we are not satisfied with the small structural adjustment component of the program. Comprehensive structural adjustment in a number of sectors is essential for Gabon's economy if the devaluation is to result in more than just another exogenous shock that is to be overcome through increased foreign borrowing. To help the Gabonese authorities strengthen their efforts to consolidate the country's non-oil economic growth in a consistent way and in a longer-term perspective, early progress in negotiations for a successor program is warranted. We encourage the staff to work with the authorities in this direction.

Mr. Yang made the following statement:

I generally agree with the staff appraisal and, therefore, will make only a few remarks. First, we encourage the Gabonese authorities to fight the sluggish economic situation prevailing in the non-oil sectors. To achieve sustainable growth and a viable external position, the authorities must prepare for the eventual depletion of oil resources. Because oil exports account for about 80 percent of total exchange earnings and this situation is likely to change in the next decade as a result of diminishing resources, the authorities should design an appropriate strategy as soon as possible. This strategy should be accompanied by comprehensive policy measures aimed at accelerating economic diversification by providing more scope for private sector resources. I concur with the staff that the recent parity change provides a unique opportunity to this end.

Second, the continued strengthening of the primary surplus in the Government's fiscal position over the next few years is of central importance to Gabon in view of debt pressures. The medium-term fiscal scenario developed by the staff is based on seven assumptions, all of them more or less subject to risk. There is no question that efforts in the tax and social areas should be made to mitigate inflation pressures and other negative effects that devaluation will have on the more vulnerable groups; the authorities are nevertheless urged to implement rigorously the envisaged revenue-enhancement and expenditure-containment measures. In this connection, while we are pleased to note the authorities' determined efforts to strengthen public finances, as stated by Mr. Obame, I share the staff's view that the public sector wage policy should be strictly maintained and any deviation in customs tariff from the regional customs union agreement should be reconsidered, because the maximum tariff under the agreement already represents a sharp drop from the previous tariff.

Third, the external debt has become more of a threat to the Gabonese economy because the amount in terms of CFA francs has doubled overnight as a result of the devaluation. To help reduce this burden, the international community, including the Fund and present creditors, should continue their general supportive stance. However, the authorities are urged to persevere with firm implementation of the Fund arrangement. We support the proposed decisions.

Ms. Bessone Basto made the following statement:

The country before us today is another example, among many in the CFA franc zone, of how overvaluation of the currency was the main cause of the lack of export competitiveness and of stagnant economic activity. In the case of Gabon, the lack of dynamism and sluggish aggregate demand is also in part the effect of the decline in oil prices on an economy that traditionally relied on the production of this commodity. Moreover, some of the reforms necessary to diversify the economy to other sectors of production were not implemented, even if significant achievements were made in improving budgetary control, especially with regard to public sector wages. Finally in this connection, the country's significant trade surplus was offset by net expenditures on services; the latter, together with large capital outflows, contributed to the wide deficit of the balance of payments in 1993, which was largely financed by an increase in arrears.

The recent devaluation of the CFA franc is expected to help restore the competitiveness of Gabon's exports and to increase its economic activity in the future. To attain these aims it is essential to control the inflationary pressures that might follow the currency devaluation. I therefore welcome the steps taken to control wage growth--in both the private and public sectors--which could play a major role, according to the staff report, in determining the evolution of prices. The attention paid by the authorities to the goal of inflation control is also reflected in other recent measures: Gabon temporarily imposed a general price freeze that was replaced later by a system of controlled margins, as well as credit ceilings. In addition, the reduction of customs duties and other taxes will contribute, at least temporarily, to limiting price increases.

The devaluation of the currency will play an important role in alleviating the negative effects of the reduction of tariff barriers on the balance of trade. Positive effects should also be expected from the recent rise in interest rates, which will help to increase savings and attract the foreign capital very much needed by the country.

I agree with the staff that even though the general recovery of economic activity resulting from the enhanced competitiveness of the economy and increased investment will create employment and contribute to improving living standards in the country, in the short term the price effect of the exchange rate adjustment might adversely affect the income of some groups, particularly the poorest classes and public sector employees. To minimize these effects, it is important that the measures proposed in the program, such as some price controls and improved social services, be implemented thoroughly.

As emphasized in the staff report, the future performance of the country will depend on exogenous factors, such as the trend of oil prices, but it will also depend on factors under the authorities' control, notably wage and price policies and customs duty revenues. As the performance of the country is subject to some risks and the program does not have much room for slippage, I expect the authorities to make every effort to achieve full implementation. With these remarks, I support the requests for the stand-by arrangement and for a purchase under the CCFF.

Mr. Al-Jasser made the following statement:

Faced with large external and internal imbalances, payments arrears, and curtailed access to external financing, the Gabonese authorities are indeed walking a tightrope. As is the case with other CFA franc zone member countries, the recent devaluation has provided Gabon with an important and timely opportunity to restore financial health to the public sector, while enhancing competitiveness. As Gabon faces many of the same challenges as other CFA franc zone countries, and I have commented on them in previous discussions, I will restrict my remarks to a few areas that are specific to Gabon.

Fiscal consolidation is clearly the centerpiece of the authorities' adjustment effort. I share the recommendations of the staff in this area. Nevertheless, it is important to emphasize that given the importance of oil revenues to the economy, as well as the uncertainties in the oil market, the authorities have little room for maneuver. Wage restraint will be a particularly important element in containing current expenditures. At the same time, equal care must be exercised in the area of capital expenditures. While government investment is clearly needed in a number of areas, it is crucial that new projects are carefully screened to ensure that only projects with a high rate of return are undertaken. Monitoring expenditures in all areas might be significantly enhanced with improved data on the functional distribution of government expenditures.

Gabon is fortunate to enjoy a level of per capita income that far exceeds that of any other member of the CFA franc zone. However, Gabon has a high cost structure and narrow economic base while reliance on oil revenues cannot be sustained in the long run. In this context, the authorities' strategy for the medium term, which includes targeting a high level of public savings, is indeed commendable. But, to fully benefit from this strategy, it will be equally important for the authorities to ensure that a strengthened structural reform program is undertaken to enhance incentives for the private sector--I note, for example, that Gabon has an untapped potential in areas such as agriculture, and I would appreciate some elaboration from the staff on possible areas of diversification.

The social safety net measures implemented in the aftermath of the devaluation are broadly appropriate for the immediate term. The pilot project for a labor-intensive works program, however, will need to be monitored carefully with a view to ensuring that all public involvement in projects remains restricted to projects that have a high rate of return.

Finally, most of the challenges facing the Gabonese authorities are of a medium-term nature. The program before us must therefore be seen as a first step toward the formulation of a more comprehensive medium-term strategy to address the challenges ahead, especially on the structural front. In supporting the proposed decisions, I would like to take this opportunity to support Mr. de Groote's views on the important issue of financing assurances.

Ms. Laframboise made the following statement:

With the exception of one issue, our preoccupations with this program have been covered by other speakers. In particular, we share the views expressed by Mr. Sirat, Mr. Wire, and Mr. Keller regarding the need for strong wage restraint, tighter budget control, and greater structural reform to improve the efficiency of investment and help reduce production costs.

We have some concerns about external financing and the program assumptions on arrears. This chair is less than pleased with Gabon's performance vis-à-vis the Paris Club. Gabon is the only country, to our knowledge, among many that have experienced equally difficult external payments crises, whose Paris Club agreement was declared null and void because of noncompliance.

With regard to the program, first, we realize that financing assurances have not been resolved until recently. Nevertheless, we would have liked to see some performance criteria for external arrears payments in the program. Second, and I think pertinent to the discussion about the relationship between the Paris Club and the Fund, we agree with Mr. de Groote that coordination and a certain amount of assumptions on extended financing are required to establish Fund-supported programs. However, it is a two-way negotiation, and I also agree with the point made by Mrs. Wagenhoefer about the risk of prejudging terms or dictating the outcome of a rescheduling to the Paris Club before it has reached its conclusions. For instance, as Mr. Wire mentioned, the staff report assumes "partial payment in the program period of arrears on post-cutoff-date debt." As presented, we *object to this assumption because it would not necessarily* be acceptable to the Paris Club, and not to this chair in any event. Perhaps the staff could elaborate on this aspect of its assumptions.

More generally, it is true that Gabon has suffered macroeconomic shocks over the past decade; however, it would also be fair to say that Gabon has failed to seize numerous valuable opportunities to correct imbalances and create sustained economic growth. While the nation certainly possesses the resources and potential to succeed, it is not surprising that we are guarded about the Government's commitment and uncertain about the prospects for success. In our view, the program could have done more on the structural side to maximize the opportunities posed by the exchange rate realignment and renewed international assistance. Nonetheless, if Gabon were to follow through on all the elements of this program, it could serve as an adequate first step to improving financial balances and preparing Gabon's economy for the eventual depletion of its oil resources. We support the proposed decisions and appeal to the authorities to apply a greater sense of urgency and consistency to their reform effort.

Mr. Golriz stated that he shared the concerns raised by other Directors, especially Mr. Al-Jasser and Mr. de Groote. But, as Mr. Obame had stated, the country was facing serious difficulties, which were mainly exogenous. The Gabonese reform efforts deserved the Fund's support, and he endorsed the proposed decisions.

The staff representative from the African Department noted, on customs tariffs and policies, that the UDEAC Bangui agreement had been reached in June 1993 when the CFA franc had been traded at its former parity. The Gabonese authorities had retained perhaps the most significant part of the agreement--the classification of goods under a uniform structure--and they had decided to proceed with a lower than agreed rate structure for each of those categories. The decision was justified from two perspectives: first, it helped to control the inflation consequences of the devaluation; and second, a rate structure that was appropriate under a certain exchange rate would, because of relative price effects, become much more protective under a new exchange rate. To derive the most from the potential for competitiveness gains in a devaluation, it made sense to reduce customs protection. Of course, cutting import protection was also one way of lowering the overall cost structure and facilitating export development.

It was not correct to say that lower import tariffs had been compensated for by higher export taxes, because the two developments were unrelated, the staff representative continued. The export taxes applied to wood, most of which was exported, and manganese, which was wholly exported. Therefore, the tax was a way for the Government to capture the mining rent, and in that sense was justified.

The balance of savings and investment, particularly as regards the distribution between the private and public sectors, would probably be the central medium-term issue in Gabon, the staff representative commented. The large financial surplus of the private sector--namely, savings--was significantly above the level of investment; one working hypothesis was that a contributing factor was the skewed income distribution in Gabon.

A second possible explanation for the high private saving rate was that non-oil taxation was low relative to government expenditure, which was quite high vis-à-vis GDP, the staff representative added. Specific to Gabon, those expenditures were covered largely by oil rent revenue, and in a small part by direct taxation, which froze resources in terms of disposable income and meant that the private sector had higher resources than otherwise. In that sense, the part of the program supporting expectations of a major increase in the primary surplus of the government sector represented a substantial structural shift in the economy.

On the other side of the savings-investment equation, private sector investment was rather low and would have to rise if Gabon were to sustain a reasonable growth rate over the medium term, the staff representative remarked. It was low to some extent because competitiveness was poor and also because the fiscal situation had inevitably deterred investment in the country. It was to be hoped that the corrections being made in the context of the program in both respects would, with a lag, lead to a higher level of investment and also to a recovery of domestic demand following the current depressed conditions.

Recent information was not available on capital repatriation and its impact on the banking system, the staff representative commented; but informally the Gabonese authorities had indicated that the interest rate differential, together with the absence of further expectation of an exchange rate change, could generate a reflow of capital. However, the tight enforcement of capital controls still in place was seen as a deterrent to that incipient reflow. The staff would study the situation, but meanwhile the banks did not appear to be awash with liquidity. Rather, the dominant impression, inherited perhaps from accounts dating back to the period prior to the devaluation, was that the liquidity situation of the banks was tight, and there was deep concern that the exchange losses that the authorities expected the private sector to experience would create liquidity problems in the economy that would filter back to the banking system.

The scope for diversification of the Gabonese economy was extensive, but no master plan appeared to be in place, the staff representative noted. There were opportunities for further geological research and mining development; significant potential in the local transformation of wood and certain minerals; room for exploitation of fishing and tourism; and, in the view of many Gabonese, a chance to promote warehouse trade and international banking facilities because of the country's favorable location.

The program included a criterion on the complete elimination of external arrears during the period covered, whether by cash payments or renegotiation, the staff representative from the African Department stated. The language in the staff report had alluded to the possibility of deferring payment of post-cutoff-date arrears because, at the time of writing, a number of options had remained open; but the staff's calculations no longer included such an assumption. However, he expected that such an agreement would be part of the Gabonese authorities' request to the Paris Club.

Mr. Obame said that he would focus his observations on the heavy debt burden facing Gabon. A historical perspective could help to better understand the problem and perhaps clarify the past use of resources, which had been questioned by some Executive Directors. In the early 1970s, oil had not been the predominant sector in the economy and had accounted for only about 30 percent of total external receipts, compared with 80 percent of those receipts in 1993, and about 50 percent of budgetary revenue.

Indeed, oil had drastically influenced the economic development process in Gabon, which had gone through several cycles of adjustment, Mr. Obame continued. The first cycle, between 1973 and 1977, was the period during which a sharp increase in oil prices had occurred and also the period when Gabon, as a new member of OPEC, had decided to accelerate its economic development. The new wealth provided by oil revenue had substantially raised Gabon's creditworthiness, and the country had borrowed heavily from willing bankers and official financial sources around the world to develop its basic infrastructure--roads and port facilities. Also part of Gabon's oil resources had been used to undertake a railroad project that the World Bank decided not to finance. Moreover, in 1977 the conference of the Organization of African Unity had been held in Libreville, and the resulting building boom of a conference center, hotels and related equipment had exacerbated Gabon's debt problem.

The second cycle, between 1977 and 1982, had seen the country emerging from the intense acceleration of infrastructure construction to a situation of large internal and external imbalances, Mr. Obame recalled. In 1978, Gabon had approached the Fund for help in its adjustment process with a successful stabilization program supported by a stand-by arrangement, which was subsequently followed by another successful program over 1980-82 supported by an extended arrangement under which even the committed resources were not drawn by Gabon.

From 1982 to 1986, another economic cycle had occurred during which Gabon, having restored its internal and external equilibria, had not found a Fund-supported program to be necessary, Mr. Obame said. Oil prices had been comfortably high, and Gabon's creditworthiness satisfactory. Therefore, the country had decided again to accelerate its development process and in particular to complete the railroad project. Once again, many investors had approached Gabon with various project proposals and Gabon had again borrowed heavily. Unfortunately, many of those projects were not completed and around Libreville many "white elephants" bore testimony to that fact. Although many projects were not completed, the loans that were contracted had to be repaid. It should also be said that during that period Gabon had borrowed short to finance long-term investments, with many of those transactions tied to oil.

Thus, the heavy debt-service burden facing Gabon was evident, Mr. Obame commented. The terms of the borrowings had not been suitable for infrastructure financing.

The fourth cycle had begun with the sharp decline in oil prices in 1986, Mr. Obame noted. It should be emphasized that Gabon had lost about 50 percent of its income since 1986. Thus, budgetary revenue in 1993 represented only half of that in 1986. Gabon had implemented three programs since 1986. While the first, during 1986-88, had been implement with a certain degree of success, the two others had encountered difficulties--particularly the latest--because the assumptions for oil had not materialized and the Paris Club had had to cancel its rescheduling agreement with Gabon.

Looking to the future, his authorities intended, as noted in the letter of intent--and supported by Mr. Sirat and other speakers--to use the resources from the oil, mining, and forestry sectors to accelerate structural reforms, Mr. Obame remarked. Gabon had asked the World Bank to help identify the sectors that could be developed most productively.

The efforts being made by the Gabonese authorities to redress macroeconomic imbalances and diversify the economy needed to be complemented by a lasting solution to the debt problem, Mr. Obame commented. While the authorities' intention was to continue servicing the debt, they also believed that, given their development objectives, debt service should be tailored to the real capacity of a country to repay. In that connection, he would point out that, with respect to Mr. de Groote's questions on the Paris Club's intentions, the latter were reflected in the assumptions in the staff report, which he considered the minimum that the Gabonese authorities could request from official creditors. While debt owed to commercial banks was relatively low, his authorities were appreciative of the efforts recently made by the London Club to reschedule to reschedule the commercial debt. But given the fact that more than 80 percent of Gabonese debt was owed to official creditors, his authorities expected even greater efforts from them at the forthcoming Paris Club meetings in reaching a meaningful agreement that could alleviate the heavy debt burden facing Gabon on a more permanent basis.

Finally, he endorsed Mr. de Groote's remark that helping Gabon would help other countries in the region, because with Gabon's potential, the spillover effects of economic recovery could only benefit those countries, Mr. Obame said. Responding to a question on intraregional trade, he noted that, at present, trade between the countries in the subregion was low because of the lack of communication infrastructure, but the authorities in the region had approached the World Bank for help in building connecting roads, and once they were in place undoubtedly increased cooperation among the countries would be seen.

The Acting Chairman said that he recalled much of the history described by Mr. Obame, and he had observed first hand the difficulties of intra-regional travel. The major challenge remained to diversify the economy; and by broadening participation, government's role could be reduced.

The Acting Chairman made the following summing up:

Executive Directors were in basic agreement with the thrust of the staff appraisal. They noted that in recent years Gabon's financial imbalances had intensified, including a large government fiscal deficit, accumulation of domestic and external payments arrears, and continuing private capital outflows that tightened the liquidity of the banking system. In addition, Gabon's cost structure remained high and its competitiveness had weakened, thus inhibiting growth in the non-oil sector and impeding the diversification of the economy.

Against this background, Directors encouraged the authorities to take the recent exchange rate depreciation of the CFA franc as a unique opportunity to restore competitiveness, support economic diversification, and improve both Gabon's growth prospects and its external position over the medium term. However, Directors emphasized that the chances of restoring domestic and external equilibrium were critically dependent on the rigorous implementation of appropriately tight financial and incomes policies. The authorities' program for 1994 was seen by Directors as a useful step in that direction, although several speakers believed that Gabon should have taken the opportunity to introduce a more comprehensive set of policies aimed at diversifying the economy.

Directors stressed that strict implementation of the authorities' decision to limit wage increases in the public sector to 8 percent in 1994, along with rigorous control of other expenditure, would be crucial for achieving the programmed fiscal target. Given the uncertain outlook of world oil prices, revenue performance would have to be monitored closely, and the authorities should stand ready to implement additional measures. Directors noted the actions taken to reduce indirect taxation of domestic petroleum products, as well as to restructure and lower customs duty rates. Together, these actions would contribute significantly to dampening inflation. Directors added that an acceleration and broadening of structural reforms was essential. In this regard, they underscored the need to streamline and liberalize the regulatory framework, eliminate the remaining quantitative restrictions on imports, and speed up the restructuring and privatization of public enterprises. These structural reforms were seen as necessary to improve the efficiency of the economy, encourage growth through the promotion of the private sector, and facilitate the achievement of a strong fiscal position.

Directors emphasized the importance of accompanying the devaluation with budgetary policies that combine a reduction in domestic absorption with support of public investments in key infrastructure projects and in human resource development. They welcomed the undertaking of the authorities to set fiscal policies within a medium-term framework that recognized the nonrenewable character of oil resources as well as the need to preserve government net wealth. They thought that such a prudent approach would help to secure an improvement in the investment climate.

Directors were of the view that Gabon would need to pursue prudent monetary and interest rate policies in concert with other members of the common central bank.

Directors observed that Gabon's adjustment efforts were taking place in an environment of depressed and uncertain world oil prices, which dampened oil exports and government revenue. They noted that, as a consequence of this and of the need to settle external payments arrears, Gabon would need to follow through with its economic policy adjustments and perhaps strengthen them in the period ahead. In addition, Gabon had large financing needs in 1994, and thus adequate and timely external support of the adjustment program, particularly through debt relief, would be essential to the success of Gabon's adjustment efforts.

Directors welcomed Gabon's intention to maintain an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, and they encouraged the authorities to accept as soon as possible the obligations of Article VIII, Sections 2, 3 and 4 of the Articles of Agreement. The authorities were also encouraged to reinstate the repurchase of CFA franc bank notes outside the monetary area. Some Directors noted the need for Gabon to better tap the potential for intraregional trade; that trade now accounted for only a small percentage of Gabon's imports and exports.

In sum, Directors remarked that Gabon is a country with substantial economic potential, including a rich natural resource base, and that positive developments in Gabon would have favorable spillover effects in the region. Concern was expressed that in the past Gabon had not adequately utilized its oil revenues to promote domestic growth and development. Looking to the future, Directors encouraged the authorities to implement macroeconomic policies and structural reforms that would enable Gabon to realize its great potential.

It is expected that the next Article IV consultation with Gabon will be held on the standard 12-month period.

The Executive Board then took the following decisions:

Stand-By Arrangement

1. Gabon has requested a 12-month stand-by arrangement in an amount equivalent to SDR 38.6 million.

2. The Fund approves the stand-by arrangement set forth in EBS/94/57, Supplement 2.

Decision No. 10633-(94/27), adopted
March 30, 1994

Purchase Transaction - Compensatory and Contingency Financing Facility - Fluctuations in Exports

1. The Fund has received a request by the Government of Gabon for a purchase equivalent to SDR 21.5 million for the compensation of an export shortfall under Section II of the Decision on the Compensatory and Contingency Financing Facility (Decision No. 8955-(88/126), adopted August 23, 1988, as amended.

2. The Fund approves the purchase in accordance with the request.

Decision No. 10634-(94/27), adopted
March 30, 1994

3. SRI LANKA - 1994 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT FACILITY - THIRD ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1994 Article IV consultation with Sri Lanka and Sri Lanka's request for the third annual arrangement under the enhanced structural adjustment facility (EBS/94/47, 3/11/94; Cor. 1, 3/28/94; and Sup. 1, 3/29/94). They also had before them a policy framework paper for 1994-96 (EBD/94/47, 3/15/94) as well as statistical tables (SM/94/67, 3/16/94; and Sup. 1, 3/17/94).

Mr. Fernando made the following statement:

Two weeks ago, in giving notice of acceptance of the obligations under Article VIII, Sections 2, 3, and 4, Sri Lanka became the first in South Asia to do so. And, in endorsing this step, the staff has signaled that the authorities stand ready to deal with any future balance of payments problems through appropriate adjustment policies and financing rather than recourse to restrictive measures. To be sure, the final step toward full convertibility in current account transactions was taken over a year ago when the few remaining restrictions were lifted. But this step, although preceded by the steady liberalization of the external sector, still involved a downside risk of capital flight in the guise of current transactions. A full year's results provide credible evidence that domestic and foreign confidence reached a new high. Gross official reserves increased by SDR 513 million, and the import coverage rose from 3.5 to 5.2 months during this test period. Inevitably, program performance criteria and benchmarks relating to net official reserves were observed consistently and with large margins to spare.

Sri Lanka's economic fundamentals have continued to strengthen. Growth performance--an average of nearly 5 percent over the past three years--and progress toward medium-term balance of payments viability, fulfills in ample measure the expectations generally set out for enhanced structural adjustment facility (ESAF) arrangements. Underpinning this performance was domestic savings, which rose by 4 percentage points over the past three years to reach 16.7 percent of GDP in 1993 with equal contributions from the private and government sectors. With this effort, fiscal adjustment has delivered a positive contribution to savings after years of dissaving. The counterpart to these developments was a further narrowing of the deficit in the current account of the balance of payments.

While higher domestic savings certainly boosted gross investment, the contribution of the latter to potential output goes beyond numerical aggregates. At work is an increase in total factor productivity on account of the much higher proportion of private investment, including foreign direct investment, in the total, as well as a shift in the relative shares of government investment into infrastructure and human capital, both supportive of private development.

Where the achievements have fallen short of macroeconomic targets has been in respect of inflation--a concern that brought on substantial monetary tightening at the time of the previous midterm review. To counteract inflation by influencing the growth of broad money (M2), the authorities sharply curtailed credit--the intermediate variable consistently used in the financial program to achieve the inflation objective. Although performance in respect of net domestic assets and credit from the banking system was broadly as programmed--ceilings having been made more stringent to compensate for earlier slippage--M2 growth through 1993 continued unabated under the intense influence of the external sector.

The growth in M2 in 1993 matched almost fully the growth of net foreign assets, and currently, reserve money is backed nearly 100 percent by the net foreign assets of the monetary authority. Surging capital flows, normally associated with successful Fund-supported programs, are now part of the economic landscape of Sri Lanka. And, to quote from the staff report, "In formulating the policy agenda...the staff and the authorities took into account the increasingly complicated nature of macroeconomic management in recent years...particularly 1993."

Although policy developments, structural reform, and economic performance combined to increase the attractiveness of Sri Lanka to fixed-investment-related capital, the prolonged period of high real interest rates signaled that part of the inflow was monetary in nature. The initial response of my authorities was to further tighten monetary policy, including through sterilization. As observed elsewhere, success has been limited, and in the event, the Central Bank has nearly exhausted its portfolio of treasury bills. While issuance of its own securities is another vehicle to mop up liquidity, the Central Bank needs to weigh carefully the impact of past and future such operations on its own profit and loss account.

There is no simple policy prescription to avoid the loss of monetary control related to capital inflows. My authorities are, therefore, responding with pragmatic measures. Indeed, they are pushing ahead with the agenda of structural reform in the financial sector and through privatization, which can be particularly effective in increasing the efficiency with which inflows are absorbed. Among the measures that address the issue more directly are the complete liberalization of the external current account and recent measures to further liberalize external trade and reduce tariffs. Also, they see some additional scope to limit the impact of capital inflows on the monetary base through stricter prudential criteria for banks' foreign exchange operations, including through limits on open positions.

That the policy approach to capital inflows could include a nominal appreciation of the exchange rate, especially to the extent that further tightening through monetary and fiscal measures is counterproductive, is well recognized by my authorities. In fact, the experience of recent months evidenced some appreciation of the rupee. To increase the latitude for economic fundamentals to influence the exchange rate, the authorities stand ready to provide added impetus to the interbank foreign exchange market through a further widening of the Central Bank's spread between the buying and selling rates for the intervention currency. They are mindful, however, of new concerns regarding export competitiveness against the background of a policy shift phasing out special incentives for exports. Balancing these various issues will require my authorities to remain flexible in implementing policy.

The Government's approach to fiscal policy has involved a careful management of the impact of adjustment policies on the short-run goal of stabilization while breaking ground on policies to secure a sustainable position over the long term. The reductions in the corporate and personal taxes and in import tariffs, while justified on the basis of wider economic criteria, nevertheless, because of immediate revenue losses, risk upsetting the fragile path of fiscal adjustment. Thus a further round in a series of tariff cuts was delayed and took effect after, rather than before, the previous midterm review. But to make up at least partially the revenue loss, discretionary measures had to be taken recently.

With many structural reforms having a negative effect on revenue, keeping fiscal targets in sight has meant a greater reliance on expenditure restraint. Over the past three years, current expenditures as a ratio of GDP had declined by 2.3 percent, with a further drop by over a full percentage point expected through 1994. The resulting reduction in the Government's recourse to the market for loanable funds should lead to an easing of interest rates and thus facilitate the task of monetary policy.

Although my authorities share some of the staff's concern regarding delays in targeting social outlays over and beyond what has already been attained, the macroeconomic impact of this should not be overstated. From 3 percent of GDP in 1990, social outlays declined to 1.7 percent last year. Moreover, it may be recalled that the most important component within this, Janasaviya, has been targeted and its overall scope adjusted to fit resource availability. As for the rest of social transfers, operational procedures for additional targeting have been settled. An easing of the political constraints would provide the momentum to move forward. That said, however, the scope for expenditure savings is minimal as the exercise will involve a redistribution away from the less eligible to the more eligible--an important contribution to make the social safety net more efficient.

The second round of civil service reform has been influenced by the legacy of the first. Through the first round, one tenth of total staff in service was retrenched, but the absorption of the entire burden of severance pay by the budget erased any possibility of savings in the near term. Despite the added complications arising from greater power sharing with the provinces, my authorities are pressing ahead with a comprehensive review of cadres in both the central and provincial governments. As a first step, and in order to secure the hiring freeze, some 60,000 vacant positions are to be suppressed under policy advice from the World Bank.

The value-added tax system due to replace the present turnover tax system is the most far-reaching measure to secure fiscal health over the long haul. The discussion at the midterm review clarified the background against which the date of implementation was rescheduled to April 1995. In light of the further revenue losses as a result of the next round of tariff cuts due at year-end, the authorities share the staff's view that no room can be left for value-added tax collections lower than the system it replaces. Detailed simulation exercises, with Fund technical assistance, are under way, and, as affirmed in the authorities' memorandum on economic and financial policies for 1994, they stand ready to make the necessary revisions. Their current preoccupation is with the enactment of enabling legislation to introduce the value-added tax. Equally important is business and consumer education to counter negative perceptions, allay suspicions, and ease the transitional risks. The broadening of the revenue base that is expected as the value-added tax takes root will provide a secure basis for the Government to forcefully address longer-term structural issues such as the funding of pensions, immediate plans for which have encountered budgetary constraints.

To conclude, liberal and market-friendly policies followed in the past 15 years, and more fully defined in the past 5 years under Fund-supported adjustment programs, are now irreversible--not because there are no structures and institutions to serve as alternatives, but because public confidence has grown and the constituency for reform is large and still expanding. A highly visible payoff is the resiliency and strength of the economy through years of a potentially destructive engagement with a separatist movement. The authorities may not have been able to give their undivided attention to economic and social development, but that has not prevented them from keeping economic policies at the top of the agenda. Inevitably, delays in some areas have been encountered as they strive to balance proper sequencing of reforms with political opportunity. The midterm review, later this year, will enable the staff to revisit the remaining areas of difficulty, notwithstanding the congestion in the political calendar toward the end of the year. My authorities thank the Board, management, and staff for the constructive role played in sustaining Sri Lanka's economic advance.

Mr. Ismael made the following statement:

Sri Lanka has joined an increasing number of member countries that are endeavoring to capture the benefits of capital inflows, but at the same time, minimize its evils. Sustained capital inflows affect the conduct of the entire spectrum of macroeconomic management with particular impact on monetary policy--constraining the effectiveness of monetary instruments, challenging the efficiency of financial intermediation, and testing the effectiveness of market structures. Several countries in my constituency, such as Thailand, Indonesia, and Malaysia, have been living with this phenomenon for some time, and most have taken advantage of the situation by picking up the pace of economic adjustment.

On the one hand, the surge in capital inflows in Sri Lanka in the past three years is a vote of confidence in the economy. Output performance has been stable, nontraditional exports are buoyant, and the fiscal deficit has come down. These capital inflows have also propped up foreign reserves and helped raise the rate of investment. On the other hand, the same capital inflows have sustained domestic demand, contributing to the slippage against the ESAF-supported program of several major economic indicators, such as inflation and money supply.

Obviously, the appropriate policy response will depend on the composition of the inflows. Unlike experiences in East Asia, where long-term direct investment accounted for about 25 percent of total capital inflows, direct investment in Sri Lanka has stagnated at only half that ratio in the past two years. Moreover, the proportion of portfolio investments, which is generally attracted by the high yields discounted by exchange rate expectations, doubled to 10 percent in 1993. The stability of the rupee against the U.S. dollar has also encouraged these unanticipated flows.

Sri Lanka's policy response should, therefore, aim at filtering out speculative flows but at the same time encouraging direct investment. Sterilization is not the most appropriate response, as it has a cyclical upward pull on interest rates. Instead, demand-management techniques should be harnessed to narrow interest rate differentials. Increased government savings should be the centerpiece of the policy package aimed at suppressing demand and reallocating resources. I welcome the contribution of the budget to domestic savings last year. This was very modest; but I look forward to an even stronger contribution this year as set out in the fiscal program. Given the very low ratio of fiscal revenue to GDP in Sri Lanka, the implementation of a more effective tax structure is the most obvious way to achieve the desirable level of government savings. In this context, I strongly urge the authorities to follow through on their commitment to narrow the latitude for exemptions and waivers of custom duties, which have eroded the revenue base in previous years.

The exchange rate arrangement is obviously important in the *transmission mechanism* of capital inflows to the rest of the economy. The lack of flexibility in Sri Lanka's exchange regime blunts the expenditure-switching role of the nominal exchange rate, which has allowed capital inflows to uphold the level of demand. A more flexible exchange rate regime will allow nominal appreciation to help moderate domestic demand. From the supply side, the erosion of the expected currency gain arising from the appreciation will offset the attractiveness in short-term yields and discourage further surges in speculative inflows. Success of the demand-management strategy on inflation will help regain the loss in competitiveness from the nominal appreciation. Competitiveness can be further strengthened by the gains in market efficiency coupled with a tight rein on cost structures.

On money supply, directed credit by the central and the state banks should be curtailed to lessen distortion in credit allocation. Recourse to more permanent and less costly monetary instruments, such as the statutory reserve requirements, should help open market operations maintain a consistent rate of monetary expansion. But the Central Bank should resist reverting to quantitative restrictions. Instead, it can exert more energy on the ongoing development and deepening of the financial market to enhance efficiencies in allocation and intermediation. I would discourage the imposition of taxes on inflows as they have not been generally effective.

In addition, venting of liquidity through the relaxation of regulations on outflows will help. In this regard, I welcome the acceptance of Article VIII status by Sri Lanka, but the country should take this opportunity to go further. Trade liberalization can be accelerated. In this regard, could the staff comment on the appropriate timing of further liberalization of the capital account and its likely implication on Sri Lanka's execution of monetary policy? I fully support Sri Lanka's request for the third annual ESAF arrangement.

Mr. Posthumus made the following statement:

The staff identifies the two key policy issues as, first, the appropriate mix of financial policies and, second, the appropriate stance of exchange rate policy. It is especially on the fiscal side that the performance in the period under review leaves much to be desired: the estimated outcome in 1993 is disappointing even with respect to the revised fiscal target, which had already been modified to allow for slippages in both revenue and current expenditure. The structural improvement in current spending envisaged under the program was not achieved. This weakness in fiscal policy, disappointing under any circumstance, presents a particular predicament given the inflows of what the staff refers to as interest-sensitive capital. While such inflows reflect a reaction to the liberalization of the current account, including acceptance of the obligations under Article VIII, and, no doubt, growing confidence in the economy, the primary factor is the high level of domestic interest rates. Faced with these inflows, the authorities should have adopted a more restrained fiscal stance.

On the other hand, monetary policy has not been strong enough to counter the expansionary effect of these inflows and sterilization efforts proved ineffective. The upshot is a rate of inflation that exceeded the target under the program, which had already been revised upward from the original target. This failure to bring inflation down could erode the hard-earned confidence in the economy. It seems that the present exchange rate policy targets real exchange rate stability through interventions, thus fully accommodating inflation. The question is what in this situation the appropriate exchange rate policy would be.

In view of the limited ability of the Central Bank to sterilize capital inflows through open market operations, the staff recommends "some nominal appreciation of the rupee...in order to ensure the achievement of monetary targets." This sounds rather vague. I wonder, and I would like some comments from the staff, if not both the transparency and efficiency of this strategy could be improved by some preannounced nominal target with a rate of depreciation that is lower than anticipated inflation and with, initially, a wide enough band around it to allow exchange rate movements in reaction to short-term capital flows. Of course, some nominal appreciation would then also occur but in a framework of a clear, anti-inflation strategy.

Sri Lanka has experienced persistently high rates of unemployment--Table 12 of Supplement 1 shows that unemployment rates of 13-16 percent have prevailed since the mid-1980s. Furthermore, these rates are high in both the rural and urban areas. The persistence of these unemployment rates is a reflection of the highly regulated and segmented labor market, as described in the background papers. It is therefore particularly disappointing to see that in the framework of the present ESAF arrangement no labor market reforms have been undertaken, nor does the program for the third annual arrangement include any such reforms. A cursory glance at the World Bank Atlas reveals that Sri Lanka compares favorably with all developing countries in terms of its human capital indicators. In fact, its primary school enrollment and illiteracy rates do not fall far behind those of some industrial countries. A liberalization of the labor market would unleash this potential for higher productivity and growth.

Equally important is the matter of poverty alleviation. The present welfare system is ill targeted and inefficient. A vast number of households benefit from transfer payments; however, the amounts are too small to sustain the truly poor. The authorities should pay heed to the staff's recommendation and eliminate from the food stamps program all those households--260,000--that were identified in 1992 as not qualifying. In conclusion, I support the proposed ESAF arrangement.

Ms. Brettschneider made the following statement:

At the time of the mid-term review of the second annual ESAF arrangement, we commended the Sri Lanka authorities on their economic performance over the course of the program. We stressed, however, that Sri Lanka would need to exhibit an intensified commitment to reform over the remainder of the second arrangement and through the third arrangement in order to realize its considerable development potential.

Sri Lanka's strong record of output growth and external strengthening is impressive and attests to the benefits of ongoing economic reform and liberalization efforts. The substantial 5.7 percent boost in GDP growth in 1993, and in the manufacturing sector in particular--9.7 percent--are laudable. Program targets in the external sector were met or surpassed in just about every area, leading to a larger than expected decline in the current account deficit and a strengthening of reserves to a comfortable five months of import coverage. The ongoing liberalization of the trade and foreign exchange regimes has led to increased confidence on the part of foreign investors, which will be further reinforced by Sri Lanka's welcome acceptance of the obligations of Article VIII.

Unfortunately, performance in a number of critical areas fell far short of what we had hoped to see in 1993. Serious slippages in financial policies and delays in structural reform put a damper on Sri Lanka's adjustment efforts as a whole. We, therefore, concur with the third arrangement's focus on tightening financial policies and redoubling efforts in key areas of structural reform. With respect to the latter, financial sector reform is especially critical and is an area to which I will return later in my remarks.

Given the warning signals at the midterm ESAF review that inflation was exceeding program targets, we regretted that the authorities were unable to regain control over monetary aggregates in the second half of the year. There is little disagreement that tightening financial policies to bring down the 12 percent inflation rate needs to be a cornerstone of Sri Lanka's adjustment program in 1994.

We recognize the challenges imposed on monetary control in 1993 stemming from large volumes of unexpected capital inflows, and we welcome the authorities' efforts to rely on open market operations to absorb increased liquidity. We concur with the staff's view that allowing some nominal appreciation of the exchange rate in line with market forces is an appropriate response to pressures resulting from large capital inflows if sterilization opportunities are limited. Further efforts in the structural reform area, specifically in financial sector reform and privatization, will also be critical to regaining control of monetary aggregates. In this regard, we join Mr. Ismael in urging the authorities to shift away from continued reliance on distortive directed credit schemes and to allow market forces to allocate resources more efficiently. As a final note on monetary developments, we would underscore the positive role that foreign capital inflows can play in boosting private sector activity in Sri Lanka, increasing investment and the tax base, and maintaining a strong reserve position.

Clearly, however, the Government's large borrowing needs have to be addressed to regain control over monetary policy, as well as to free up resources for private sector activity. Fiscal consolidation is essential. Slippages in 1993 on the fiscal front are, therefore, particularly troubling, and, we fear, will be exacerbated by the weakness of revenue and expenditure measures outlined for 1994. On the revenue side, virtually no progress is envisioned in revenue gains in 1994. While we understand that the tariff and tax reforms that have been implemented are expected to lead to gains in the medium term, we regret that those measures were not accompanied by the timely implementation of the value-added tax and reform of the turnover tax as originally planned, which would have led to an earlier broadening of the tax base and improved tax elasticity. The news contained in Supplement 1 to the staff report that additional import duty waivers and turnover tax concessions have been granted raises further doubts with respect to the depth of the authorities' commitment to fiscal discipline.

Given the weakness of the envisioned revenue measures in 1994, stringent steps need to be taken to cut government expenditures, and in this area, as well, we have a number of concerns. Specifically, we had hoped for more progress in reducing the burgeoning wage bill, which, after the early implementation of the civil service wage increase, exceeded program targets in 1993. We, therefore, welcome the inclusion of a ceiling on wages and salaries as one of the performance criteria under the program for 1994. Substantial action in the near term to carry out the delayed civil service and pension reform is also a critical step, and we look forward to reviewing the detailed action plans to address both of these issues later this year. With respect to capital expenditure, we welcome the progress the authorities have made in identifying low-priority projects for elimination, as well as their cooperation with the World Bank on the core investment program. We hope the core program will ensure sufficient budgetary attention to priority social sectors, especially to the poorest segments of the population.

On structural reform, we welcome progress in the areas of foreign exchange and trade liberalization, as well as public enterprise reform and privatization. However, we continue to be disappointed with the slow pace of financial sector reform, with delays in the reform of banking legislation a prime example. We join the staff in highlighting the need for urgent action to remedy delays in this critical area. The measures outlined in the third-year ESAF arrangement are appropriately directed at enhancing the efficiency of financial intermediation and improving indirect monetary management, which is especially critical in light of increasing complexities in Sri Lanka monetary management. We urge the authorities to move away from government involvement in the banking sector in order to increase competition, lower intermediation costs, and increase the role of market forces in credit allocation. Toward that end, we welcome the involvement of the Fund and the World Bank in the intermediate phase of financial sector reform, and we hope for expedited progress in this area.

Finally, the report notes that Sri Lanka's medium- and long-term outlook is subject to more than the usual number of risks. While we recognize that 1994 is an election year with the political sensitivities this entails, we urge the authorities to demonstrate continued commitment to financial discipline and structural reform. We are in strong agreement with the staff's view that the deferral of major action will only accentuate the impact of past delays. An intensified effort on the part of the authorities is needed to build on the strong foundation Sri Lanka has already established in order to ensure sustainable growth in conjunction with inflation objectives over the medium term. With these remarks, we support the proposed decision.

Mr. Al-Tuwaijri made the following statement:

The Sri Lanka authorities deserve to be commended for persevering with their adjustment efforts and building upon their previous achievements. Output growth, the current account deficit reduction, and gross official reserves exceeded program targets.

The authorities were not as successful, however, in containing inflationary pressures. Like many countries that are successfully implementing adjustment programs, Sri Lanka is enjoying an increase in confidence that has encouraged capital inflows. This trend has been reinforced by high domestic real interest rates. While these inflows have opened up new opportunities for growth, they have also given rise to increased inflationary pressures. Inflation has also been fueled by the wage increase granted to civil servants in August 1993. Therefore, the major challenges facing the authorities at this time and over the medium term are to maintain the impressive growth performance while substantially reducing the inflation rate.

The program for 1994, if fully implemented, would go a long way in realizing these objectives. The planned reduction in the fiscal deficit in 1994 is a step in the right direction, and the emphasis placed on containing current expenditures is welcome.

The latter should reduce the pressure to limit capital outlays, which are crucial for sustained growth. In this regard, the prioritization of capital expenditures in collaboration with the World Bank should also increase the efficiency of expenditures. Vigilant adherence to the expenditure objectives is critical for enhancing confidence, as well as realizing the inflation target.

On the revenue side, the planned structural reforms in the tax and tariff systems should not only improve the elasticity of revenues but should also provide a stimulus to private sector activity. In this regard, I agree with the staff that measures to redress the shortcomings of the present draft value-added tax law before its introduction are critical. Adherence to the plan to strengthen tax enforcement and improve tax administration is also needed.

An improved fiscal performance should facilitate the implementation of a tight monetary stance without putting undue pressure on interest rates. The plan to reduce subsidized interest lending to certain sectors while completely phasing out short-term lending by year-end is noteworthy. Structural policies could also play an important role in enhancing the effectiveness of monetary policy. Particularly valuable in this case are financial sector reforms, including strengthened supervision, as well as trade and capital account liberalization. Indeed, the measures implemented in these areas, as well as those that are planned for 1994, are important. Continued timely progress in eliminating structural rigidities and in the divestiture program would not only contribute to inflation reduction, but also raise productivity and competitiveness in world markets.

In the external sector, the authorities' acceptance of the obligations of Article VIII is welcome. It is also encouraging to note their intention to allow market forces to play an increasing role in exchange rate management. Such an approach could be helpful in increasing the effectiveness of monetary policy in containing inflation. I support the proposed decision.

Mr. Wei made the following statement:

I highly commend the Sri Lanka authorities for the continued strength of their economic performance, which is due mainly to their strenuous efforts during the program period. More important, it is encouraging to see that they have accepted the obligations of Article VIII, Sections 2, 3, and 4. As stated by Mr. Fernando, this shows their resolve to rely on appropriate adjustment policies to deal with future balance of payments difficulties, instead of seeking restrictive measures. Given the authorities' track record during the program and their recent external viability, I agree with the staff that the medium- and long-term prospects for Sri Lanka continue to be promising. In this context, I support the proposed decision.

However, some problems remain a source of concern. If not checked properly, these might tarnish the shine on Sri Lanka's future path to sustainable economic development.

In 1993, some slippages and faster than expected monetary growth, among other factors, undermined the authorities' efforts to bring down inflation. To a large extent, these challenges reflect the authorities' macroeconomic-management difficulties. In the fiscal area, revenue shortfalls were the result of structural reforms in several areas. These reforms will benefit the efficient allocation of resources in the longer run, although they will have some negative effects on revenue in the short run. As regards monetary and credit policy, net domestic assets and credit from the banking system were well within the program targets. However, the institutional weakness of monetary control made it difficult for the authorities to sterilize the expansionary effects with large capital inflows. In this context, I agree with the staff that in fighting inflation more weight should be given to fiscal policy.

A value-added tax will be introduced in 1995 as agreed during the last midterm review, but it will be difficult to broaden the tax base as desired in 1994. At the same time, although conducive to long-term economic prospects, reductions in income tax and tariff rates will temporarily reduce revenue. Against this background, the Sri Lanka authorities have recognized that they will have to depend more on expenditure cuts. Because capital expenditure should be secure to lay a better groundwork for private investment, the room for maneuver seems to lie with current expenditure. Owing to the authorities' strenuous efforts, current expenditure as a ratio of GDP had fallen significantly, with social outlays declining markedly from 3 percent of GDP in 1990 to 1.7 percent in 1993. In light of the hardships for society, such endeavors are formidable and courageous. Against this background, I see limited room for further adjustment in social outlays and the pension system.

I appreciate the authorities' pragmatic approach in dealing with capital inflows when conducting monetary policy. Given the insufficient institutional foundation for monetary control, appreciation of the rupee would seem to be an alternative solution for coping with the unfavorable effects of capital inflows. However, this will affect exports, particularly after the phasing out of special incentives for exports. As external viability is vital for domestic and foreign confidence, caution should be exercised in considering exchange rate appreciation. In this connection, we share the authorities' view that emphasis should be placed on the reduction of interest rates in 1994 while taking due consideration of its impact on inflation. An appropriate interest rate reduction will have many positive results, notably ameliorating the high cost of deficit financing and spurring economic growth. In addition, I would like to compliment the authorities on the liberalization of their exchange and trade regimes. For a developing country, Sri Lanka's tariff levels have been reduced remarkably compared with the pre-program period.

All in all, we hope that macroeconomic stabilization and structural reforms can be developed in the medium term. As prospects remain promising, the authorities are encouraged to continue to pursue these goals in a relatively smooth fashion so that the economy will not be too hard hit. Such a blow would erode both domestic and foreign confidence in Sri Lanka policy credibility, which is crucial for the success of adjustment efforts in the long run.

Mr. Oya made the following statement:

I would first like to congratulate the Sri Lanka authorities on accepting the obligations of Article VIII. Performance in economic reform has been mixed with regard to both macroeconomic management and structural adjustment, and I would like to comment on the policy issues that need to be addressed urgently in the period ahead.

With respect to macroeconomic issues, the containment of inflation should be given the highest priority. The key to attaining this objective is effective monetary management and fiscal consolidation. To this end, the authorities should vigorously implement revenue measures, including tax reform and a strengthening of tax administration. At the same time, a mechanism for expenditure control must be maintained. In this respect, I welcome the authorities' intention to take compensatory measures if slippages emerge during the year.

In addition, in the context of containing inflation, it is crucial to depart from the past policy of gradual nominal depreciation. In view of the current limited capacity of the authorities to sterilize huge capital inflows, the authorities should, as the staff rightly points out, allow the exchange rate to appreciate in line with market forces in order to slow the pace of speculative capital inflows and dampen inflationary pressure. It seems that the authorities are still concerned about the loss of external competitiveness resulting from the nominal appreciation. I agree with the staff that Sri Lanka's external competitiveness, as evidenced by the recent strong export experience, has already been enhanced, and therefore a modest nominal appreciation would not jeopardize the competitiveness of the tradable goods sector.

On structural reform, two areas have implications for fiscal consolidation. First, the authorities should give immediate priority to the introduction of a value-added tax. It is regrettable that there remain certain elements on which the authorities and staff cannot reach agreement in the draft legislation that was approved by the Cabinet recently. I urge the authorities to limit significantly the number of items to be taxed at the lower rate, to reduce exemptions as advised by the staff, and to ensure introduction of the value-added tax in April 1995.

Second, I am concerned that the Government has postponed the formulation of a civil service pension reform plan because of the sensitivity of this issue in the current political situation. In this respect, as well, I join the staff in urging the authorities to proceed as quickly as possible to address this issue with World Bank assistance.

Both the introduction of the value-added tax and the formulation of the civil service pension reform plan have been delayed for political reasons. Although I can understand the difficulty of implementing unpopular policies, I would emphasize the importance of maintaining the momentum of the reform process by implementing all the measures in the program. Sri Lanka has entered the third year of the ESAF arrangement, and I hope that the authorities will complete all the remaining measures required under the program by the end of the arrangements period. With these remarks, I support the proposed decision.

Mr. Dorrington made the following statement:

The staff correctly points out that there have been some significant achievements over the five years of reform in Sri Lanka and that medium-term prospects remain good. But the words "delay" and "postponed" appear far too often in the descriptions of the past in the staff report, and even more worrying, *in the supplement; some important prior actions have* been taken, but others have not. I also agree with the staff that now is the time to accord inflation reduction and fiscal adjustment top priority.

It is of great concern that the necessary restructuring of current expenditure--that is, civil service and the welfare system--has been deferred. The risk of political expediency prolonging structural reform of the budget seems to be quite high. I hope that the authorities will be able to resist further increases in civil service wages this year in spite of high inflation.

Given the continued delay in implementing the value-added tax, I strongly welcome the Cabinet's approval as a formal performance criterion. However, I share the staff's concern over the planned number of items in the lower value-added tax bands and exemptions, and I hope that this difference can be reconciled before June. Moreover, it is essential to synchronize tax changes in order to avoid a revenue shortfall. I have the impression that Sri Lanka has implemented the easy tax reductions--reducing corporate income tax and export taxes--but has delayed the more difficult tax increases--such as the value-added tax. This has led to slippages in targets that have been made up for by hasty but not necessarily sustainable corrective actions.

Monetary policy has been complicated by the large capital inflows. Statements by Mr. Ismael and other speakers make it unnecessary for me to say more than that the only sustainable way to deal with these inflows is by either tightening fiscal policy or allowing the exchange rate to appreciate somewhat, or both.

I welcome the authorities' plans for comprehensive reform of the financial sector, including the package of commercial and central banking legislation under preparation. But again I see risks of a delay in implementation. Priority must be given to the development of indirect policy instruments, better supervision--including international capital standards--and greater operational autonomy for state commercial banks. Legal changes alone will not be sufficient to improve efficiency and profits.

I can applaud the success with export-led growth, especially arising from garments and nontraditional exports. However, I would encourage continued efforts to diversify the export base.

There has also been some success with the privatization process; this needs to continue, even into sensitive areas such as the plantations. The tea plantations are more efficient under private management, but for the moment they remain subject to government interference, for example, with respect to wage increases. More generally, I agree with Mr. Posthumus's comments on labor market reform. The Government needs to press ahead with reform and restructuring of the largest loss-making public enterprises. Although some progress is being made with railways and electricity, developments elsewhere have been slower, and this has led to delay of the World Bank economic restructuring credit.

Of course, like other speakers, I welcome the authorities' decision to accept Article VIII status. Capital controls bar foreigners from investing in government securities, but the staff suspects that these controls are being circumvented by using expatriate Sri Lankans as a conduit. This not only involves inefficiencies but must surely provide scope for fraud by the individuals concerned. This reinforces the usual reasons for calling for a dismantling of such controls.

It is debatable whether approving this third annual arrangement under the ESAF is necessarily the best way forward. There is no immediate balance of payments need, and political considerations are leading the authorities to defer major action on some important structural fiscal issues. It might have been more appropriate to consider some form of enhanced surveillance for this year with a view to agreeing on a third-year ESAF arrangement after the elections, with all the prior actions having been taken and with a clear timetable for subsequent uninterrupted decisive action.

I respect the fact that the staff had to make a judgment on this point, and that they have concluded that this program is better than none. I accept the staff's judgment, although it might not have been our own, and thus I can go along with the proposed decision. Having said that, I want to underline the importance of pressing ahead with public expenditure reforms as outlined in the staff report and of addressing the weaknesses in the present draft value-added tax law before its introduction. The staff rightly states that the deferral of major action in many areas will only accentuate the impact of past delays; therefore, it is particularly important that the authorities and the staff should reach understandings on the timetable for implementation of these important reforms before the Board discusses the midterm review. The second tranche of this annual arrangement requires adherence to end-June performance criteria, but the period between end-June and the elections will be crucial--there must be no slippage. Thus, I hope that the staff will pay close attention to performance after the end of June in deciding when and if to bring the review of this program to the Board.

Mr. Cailleteau made the following statement:

Sri Lanka has made significant progress under the first and second annual ESAF arrangements. But while the economic fundamentals have strengthened, the inflation rate remains a matter of concern. Indeed, the level of inflation reflects the weakness of domestic monetary responses to capital inflows in the context of a relatively loose fiscal policy. As recalled by the staff in its background paper, this brings to the surface the inherent incompatibility of pursuing an unbalanced policy mix while maintaining export competitiveness and reducing inflationary pressures.

Domestic monetary responses are indeed exhausted. In a context of large unanticipated inflows of interest-sensitive capital--the background paper shows that the flows have been prompted primarily by a restrictive credit policy--the monetary authorities have decided to sterilize, that is, to exchange bonds rather than money for foreign exchange assets.

The problems related to such a policy are at least twofold. First, this policy is costly for the Central Bank: the net cost is the difference between interest rate levels on domestic bonds--which are high--and the return on foreign reserves. But it is all the more costly for the whole economy because it deprives the economy of the benefits of capital inflows and increases the costs of providing capital for the private sector as well as of financing budget deficits.

Second, such aggressive sterilization yields counter-productive results. By increasing the supply of bonds, the Central Bank has put upward pressure on domestic interest rates. As long as the premium on long-term interest rates exceeds the exchange rate risk, this policy cannot limit capital inflows but, on the contrary, stimulates them with the adverse effect of raising the cost of capital. The degree of sterilization, defined as the ratio of the decrease in net domestic assets of the Central Bank to the increase in currency in circulation, has risen from 122 percent in 1991 to 386 percent in 1993. And despite this intensification, this policy has had only limited success in alleviating the monetary impact of continuing inflows.

This explains why the authorities--rightly in my view--decided in October to ease the degree of sterilization. I would like to recall, in support of this shift in their policy, that in the case of Colombia in 1992, a marked reduction in sterilization resulted in a large drop in short-term interest rates, a slackening of the inflows, and a deceleration of monetary aggregates.

More generally, I would add that the other domestic tools at the disposal of the monetary authorities are also questionable. It is suggested to limit further banks' open foreign exchange position. But, along with the improvement of supervision and prudential standards, one could argue that such a solution may increase further the attractiveness of the financial market in Sri Lanka.

As indicated by Mr. Ismael, the authorities need to rebalance their policy mix in order to alleviate the over-burdening of monetary policy and reorient it toward the reduction of domestic inflation. Regarding this objective, I fully share the recommendations of the staff concerning the fiscal area, even if I can understand the reasons why the authorities plead for some gradualism in the implementation of structural reform. But it is clear that a straightforward solution to the current slippages in the program is a significant tightening of the fiscal policy.

Another avenue to be explored is the real appreciation of the exchange rate. In 1990, Mexico and Chile, in the face of similar surges in capital inflows, moved to greater, albeit limited, flexibility by enlarging the band within which their exchange rates moved. I would not advocate a move to a mere floating rate system, but I wonder whether the time is not ripe for the authorities to change the working of the implicit crawling peg. After several years of gradual depreciation of the rupee against the dollar, a signal by the authorities that they intend to stabilize the exchange rate or at least review the focus of the implicit crawling peg through a preannounced nominal target, as advocated by Mr. Posthumus, could create a salutary shock, on both external and internal expectations. Short-term flows would become more risky, and, more important, inflationary expectations could be quelled. With these remarks on the monetary approach of the macroeconomic strategy of Sri Lanka, I fully support the proposed decision.

The staff representative from the Central Asia Department remarked that the appropriate timing for the opening up of the capital account was an important and complex issue. In principle, the authorities and the staff agreed that a formal opening should take place as soon as possible, but, as Directors were aware, the financial system had not developed sufficiently to accommodate large capital movements. The staff had urged the authorities to first improve the working of the system, and the authorities were taking appropriate measures to make it more efficient.

As to exchange rate policy, Directors' views had differed on the degree of flexibility desirable, the staff representative recalled. Over the past few years, the authorities had practiced an informal preannounced depreciation strategy to take account of inflation differentials, and participants in the financial markets had taken that practice into account when placing money in Sri Lanka and withdrawing it as financial assets matured. Despite the large capital inflows, the exchange rate had depreciated, exacerbating the difficulty of maintaining a cautious monetary policy stance.

Labor market rigidities and the underlying laws and regulations were the major obstacle to labor reform, the staff representative from the Central Asia Department commented. Previous staff missions had raised the issue during negotiations for the first annual ESAF arrangement. At that time, the authorities had described the political sensitivities related to changing the regulations and had noted that the increase in privatization would reduce unemployment and labor rigidities. The staff would pursue the matter with the authorities.

The staff representative from the Policy Development and Review Department added that current account convertibility often provided an opportunity for disguised capital flows; therefore, Sri Lanka's capital account was probably more open than was apparent. Also, he would point out that in some countries, opening up the capital account had not reduced the pressure of inflows but had, in fact, aggravated the situation by stimulating additional inflows. In Sri Lanka, the problem of acute capital inflows had existed only for the past year-and-a-half. Meanwhile, the staff had urged the authorities to use a nominal rate more flexibly in order to achieve a real appreciation.

Interesting conclusions could be drawn from the Board's discussion (Seminar 93/4, 7/21/93) on recent experiences with surges in capital flows, the staff representative continued. First, in many cases, countries had been reluctant to move to nominal exchange rate flexibility until they were assured that the move was sustainable. Thus, many countries had waited until there was evidence that the inflows were in response to a systemic policy change, such as structural reforms that had stimulated productivity and profitability in the traded goods sector. The fact that such evidence was not completely in hand in Sri Lanka could explain the authorities' reluctance to undertake a change.

Second, the paper prepared for that discussion (SM/93/113, 5/21/93) reported that for many of the countries reviewed, the orderly absorption of capital inflows had taken from three to four years, the staff representative from the Policy Development and Review Department noted; in those countries, structural reforms and a favorable current account position had allowed the inflows to be absorbed without undue inflation. Clearly, the challenge for Sri Lanka was to use the inflows more productively, and Directors had pointed appropriately to the need to accelerate structural reforms so as to allow efficient absorption.

Mr. Posthumus commented that the situation facing exchange rate policy in Sri Lanka was new and complicated. He recognized the need for caution in recommending a specific policy stance; nevertheless, he would suggest a different system. Rather than the authorities' preannounced depreciation strategy, he recommended depreciation lower than the anticipated rate of inflation, so as to strengthen the anti-inflationary stance. The present system signaled that inflation remained so high that Sri Lanka could not afford appreciation of the real exchange rate. Chart 2 did not seem to indicate a real effective exchange rate depreciation over time, but rather revealed an appreciation over the past four or five years. That trend supported his view that the policy of having the nominal rate closely follow inflation had in fact accommodated inflation.

Mr. Bergo made the following statement:

The Sri Lanka authorities are to be commended for having achieved strong economic growth in 1992 and 1993, and for their acceptance of the obligations of Article VIII. However, on the whole, the experience has been mixed, as the staff reports, with regard to both macroeconomic management and structural reform. On the macroeconomic side, the most serious shortcoming was the failure to reduce inflation in line with program targets. On the structural side, the most serious slippages were with regard to tax reform and financial sector reform.

In my view, the proposed third-year program addresses these problems in an adequate manner. Its emphasis on fiscal consolidation and long-overdue tax reform is well placed. I particularly welcome the fact that the staff this time has included the most urgent reform measures among the prior actions. However, it is regrettable that, owing to previous slippages, key macroeconomic targets for 1994 have had to be less ambitious than in the first ESAF-supported program. Furthermore, the information provided by the staff in the supplement to the report indicates that there are delays and a certain backtracking on prior actions already taken. This is worrisome, and I urge the authorities to vigorously follow up not only the letter, but also the spirit of the program.

For the rest, I am in broad agreement with the staff's recommendations and with the comments and concerns expressed by other Directors, so I can limit my comments to a few points.

On macroeconomic policy, efforts to reduce inflation have to be intensified significantly. I agree with the staff's recommendation to shift the emphasis of the policy mix toward fiscal policy to this end. The budget deficit needs to be reduced significantly. In addition to the revenue-enhancing and cost-reducing measures mentioned in the report, I wish to stress the need to support this policy by proceeding promptly with reforms in the fiscal area. Thus, the value-added tax needs to be introduced as soon as possible. However, I agree with the staff that before the legislation is adopted by Parliament, the weaknesses of the present draft law should be addressed.

In addition, reforms in the areas of civil service, social welfare, and pensions are urgently needed. It is a matter of concern that such reforms have been postponed for political reasons and that no timetable exists for their implementation. To reach agreement with the staff on this matter by the time of the midterm review should be a minimum requirement. All the reforms I have mentioned are essential for strengthening the fiscal position and reducing the high inflation rate.

I also wish to join the staff in emphasizing the importance of proceeding with financial market reform. This would also support macroeconomic policy by improving the framework for monetary policy. I note with satisfaction that submitting legislation in this area to Parliament for approval was among the prior actions, and I understand that this action has now been taken. With these comments, I concur with the proposed decision.

Ms. Kouprianova made the following statement:

During the past few years, Sri Lanka has implemented macroeconomic stabilization and structural reform policies supported by an ESAF arrangement. Despite difficulties, Sri Lanka has made progress in improving its economic performance: real GDP growth was in line with projections, as was the reduction of the budget deficit; public expenditures have been reduced; gross reserves have increased; and structural improvements have been on track. Given the progress made to date, I fully support the proposed decision on a third annual ESAF arrangement, whose main goal is to help Sri Lanka's authorities continue sound financial policies and ensure macroeconomic stabilization. As other speakers have provided a comprehensive analysis of the present situation, I would just like to comment on Sri Lanka's macroeconomic performance over the past year and on some issues concerning the program.

As noted by other Directors, Sri Lanka's economic performance in 1993 was on balance quite mixed. The real GDP growth target of 5.7 percent was met, as were the savings and investment indicators. Export volume increased dramatically, thus strengthening the external position, and the volume of gross official reserves also increased. However, the target for inflation reduction was not achieved, and inflation reached almost 12 percent in 1993. Moreover, the increase in broad money growth by 5.5 percentage points in one year--reaching 23.4 percent in 1993--has fueled inflationary pressures on monetary policy, which continues to be the most important issue. The attainability of program targets will depend on the reduction of the level of inflation and on the contraction of broad money growth.

The third annual arrangement targets a reduction in the inflation rate by 5.5 percent in 1996 and a decrease of broad money growth by 7.1 percent during the coming year. I strongly hope that these levels will be achieved, and we urge the authorities to implement the program measures.

The increase of capital inflows, which was monetary in nature, placed an additional burden on monetary aggregates. I agree with the staff's suggestion that a modest appreciation of the rupee would be helpful. I also share the staff's view on the necessity of revising Sri Lanka's exchange rate system to make it more flexible and market oriented.

With respect to fiscal policy, the authorities' effort to adhere to the program target of containing the overall deficit at 8 percent of GDP is commendable. Nonetheless, scope for improving the fiscal balance remains in several areas. The revenue effort should be strengthened by improving the tax structure, increasing the elasticity of the tax system, and broadening the tax base. And, as this chair noted during the previous discussion, the delay in introducing the value-added tax--until April 1995--and the turnover tax will further inhibit the revenue effort and increase budgetary imbalances. As for expenditures, it is important to restrain government expenditures, especially on military spending, and to limit capital spending. I fully share the suggestion in the staff report that there should be greater reliance on fiscal restraint to significantly reduce the overall deficit and augment budgetary savings.

Structural policy remains the important cornerstone for economic recovery. I commend the authorities for their commitment to implement positive tax and privatization changes, but I urge the authorities to expand development of the private sector, whose activities are restricted by administrative and legal barriers. Sri Lanka has a dominant foreign sector which makes the implementation of macroeconomic reforms more difficult.

Besides the implementation of the privatization process, the program requires an improvement in the financial and economic performance of state-owned enterprises. The external position continued to strengthen in 1993, with a decrease in the current account deficit by almost 1 percentage point over the past year, and an increase in gross official reserves of 1.7 months of imports. The debt-service ratio increased by 6.5 percent in 1993, and total medium- and long-term debt was reduced by 2.7 percent compared with the previous year.

I commend the authorities for adopting the obligations of Article VIII. This reflects the commitment of the Government to solve balance of payment problems through adjustment and financing rather than through restrictive measures. I strongly hope that the Sri Lanka authorities will succeed in pursuing macroeconomic stabilization and structural adjustment policies so as to achieve sustainable growth and a strong external position.

After adjourning at 1:00 p.m., the meeting reconvened at 2:30 p.m.

Mr. Shaalan made the following statement:

At this stage of the discussion, I shall focus my remarks on certain key issues that I believe are crucial for further progress in economic management in Sri Lanka. While a significant amount of success has been achieved in the current reform effort, there are still some disturbing areas that could merit the authorities' attention. I am, of course, referring to issues underlying the attainment of a more stable macroeconomic environment and, in particular, inflationary pressures which, though they have been falling in recent years, remain stubbornly high. These pressures are fueled by a precarious budgetary situation, not only in 1994 but possibly in the medium term as well.

While a credible effort is planned for the 1994 budget deficit, which is targeted to decline by about 1.5 percentage points to about 5 percent of GDP, for a number of reasons I feel the downside risk is high. The past record clearly indicates that tax administration is weak and expenditure control mechanisms need substantial strengthening. Attention to these areas is important for attaining the programmed target.

I note that one of the factors behind the budgetary outturn for 1993 was the unexpectedly high privatization proceeds. This, of course, is a nonrecurring revenue item in the budget. As such, its inclusion leads to a higher level of expenditures, which would be difficult to curtail in the future when privatization proceeds recede. I would appreciate the staff's comments on this aspect.

The staff clearly states that there is little room for mobilizing additional revenue in the short run. In fact, the staff rightly goes further by raising the distinct possibility of revenue losses in the current fiscal year associated with the introduction of tax reforms. However, the staff believes that, should revenue performance prove to be weak during the year, the authorities should take corrective measures without delay to attain the deficit target. Here, I would like to raise two issues. First, how realistic is it administratively and legislatively to introduce compensatory revenue measures, or for that matter, expenditure-reduction measures immediately? And second, assuming that these "stand-by" measures can be taken, have they been identified? I would appreciate the views of the staff on this point.

The favorable medium-term budgetary outlook is predicated on the introduction of structural reforms in the budget, both in the revenue-mobilization area as well as in the composition of budgetary outlays. These measures would enhance the elasticity of the tax system and reduce pressures on expenditures, thereby reducing the need for ad hoc fiscal measures, and would make the tax system more predictable. This predictability aspect of tax policy is, I believe, an important attribute of any good tax system. While the delay in introducing these structural reforms is unfortunate, it is understandable; introducing solid reforms of this type is a time-consuming process. I would, however, urge the authorities to speed up the process.

Regarding monetary policy and the complications the authorities face in managing monetary aggregates in the face of heavy capital inflows, I support the authorities' stance on reducing sterilization, which can be self-defeating and would, in the case of Sri Lanka, entail heavy budgetary costs that the country can ill afford at this juncture. Opting for a small nominal appreciation has much merit in these circumstances. However, I would like to raise a hypothetical question. The staff does not seem to be concerned about a small nominal appreciation, which, if inflation continues at the pace of the past two years, could result in a real effective exchange rate appreciation of possibly some 15 percent. The staff further asserts that such an appreciation would not adversely affect the country's international competitiveness. I am not going to ask how this judgment was reached. I would like, however, to raise the following issue: if competitiveness were endangered by the aforementioned appreciation, what would have been the staff's policy advice in these circumstances?

With these remarks, I support the proposed decision.

Mr. Blome made the following statement:

I welcome the improvements achieved under the first and second annual ESAF arrangements, especially the impressive growth rate and the increase in reserves, but at the same time, I note that there are still some weaknesses in program performance, such as delays in tax and public expenditure reform and the stubborn inflation rate.

The third-year program, now presented to the Board, rightly aims at a substantial reduction in inflation, but the structural component of the program appears to be somewhat weak, as a number of major reforms originally envisaged in the areas of value-added tax introduction, civil service restructuring, and welfare program rationalizing have been postponed until after the elections. In addition, recently the authorities have somewhat weakened already implemented reforms in the area of trade and tariffs, which is another cause for concern. I thus fully support the staff's recommendation that the authorities should reach understandings with the staff, until the time of the midterm review, on a definite timetable for the implementation of further structural reforms. As a minimum, the implementation of major measures in the above-mentioned areas should start in the second half of the third-year program. I would also encourage the authorities to consider additional structural reforms, especially the privatization of plantations, as pointed out by Mr. Dorrington, and liberalization of the labor market, as proposed by Mr. Posthumus.

On a related issue, I am concerned about the Government's decision to purchase two aircraft for Air Lanka, because this action would put a considerable strain on the balance of payments and would damage the airline's already weak financial position further. In addition, I note that this plan was one of the main reasons for the decision of IDA not to proceed with the second economic restructuring credit at this time. As the retreat of IDA could substantially impair the Government's adjustment credibility in the area of structural policies, I urge the Government to review its plans regarding the fleet of Air Lanka and to accelerate implementation of the additional reforms that are a precondition for the disbursement of the IDA loan.

On macroeconomic policies, I welcome the aim under the third-year program of a substantial reduction in inflation through a significant tightening of financial policies. I also support the envisaged shift in the policy mix toward greater reliance on fiscal restraint, because the effectiveness of monetary management is at present limited owing to the problems associated with capital inflows. As the potential for further revenue generation is also rather restricted, at least in the short run, I conclude that the success of the program hinges primarily on the curtailment of government expenditure.

It is in this area that the largest program risks exist. The envisaged expenditure restraint will be difficult to maintain in an election year, especially with respect to the planned civil service reduction, the containment of the wage bill, the increase in administered prices for basic products such as wheat flour, and the actions to improve targeting of social welfare programs. In addition, the experience of previous years demonstrates that possible overruns of defense outlays in the context of the ongoing civil conflict cannot be ruled out. I would thus underline the need for strict implementation of the planned measures and for an immediate formulation of contingency measures to safeguard the program against unexpected expenditure overruns.

As for monetary policy, I wonder whether the sharp decline in domestic interest rates during the February-March period was partly caused by some relaxation of monetary policy, as the decline was most pronounced in the short-term market. It is disquieting to note, in this context, that some interest rates seem to have turned negative in real terms since February. I would thus underline the need to continue a restrained monetary policy in view of the still-existing inflationary pressures. In addition, the authorities should also consider a strengthening of their exchange rate policy along the lines proposed by Mr. Posthumus.

On external sector policies, I am somewhat concerned about the relatively large current account deficit, which will increase by another 1.4 percent of GDP to 6.7 percent this year, and will remain at about 5 percent of GDP at least until the year 2004. The development of the external current account is subject to a number of risks that could endanger the attainment of a viable balance of payments position; these risks include the possibility of a reversal of recent capital inflows, an import surge under the liberalized trade regime, shortfalls in donor assistance, and slower than hoped-for growth of nontraditional export because of stronger competition from other developing countries also aiming at export diversification. In view of all these risks, I feel that the authorities should aim at a considerably lower current account deficit over the medium term. I also support the staff's recommendation that the authorities should not contract any new commercial debt to finance these large deficits. With these observations, I can support the proposed decision.

Mr. Ahmed made the following statement:

I can certainly agree with Mr. Fernando's statement that Sri Lanka's economic fundamentals have continued to strengthen. In a number of important respects, 1993 has been a very good year with the economy showing encouraging signs of vitality: economic growth has accelerated to an average of 5 percent over the past three years; private investment in 1992 and 1993 has risen by some 50 percent in real terms; and the external position has strengthened, led by continued strong growth in nontraditional exports and large capital inflows. Although there was some slippage in current account operations, the overall fiscal position was broadly on track. Concurrent with these developments, important structural reforms were implemented--including important actions to liberalize trade restrictions and rationalize the tariff structure--and the authorities have recently announced the acceptance of the obligations of Article VIII. These are accomplishments for which the authorities deserve to be commended.

Like other Directors, we are in substantial agreement with the main elements of the staff's analysis and policy recommendations. The most urgent task facing the authorities in the period immediately ahead is to bring down the rate of inflation. As this chair has noted in the past, the persistence of inflation in Sri Lanka has tended to mar an otherwise good track record of adjustment and policy implementation.

To be sure, the task of subduing inflationary pressures is being complicated by an unexpected surge in capital inflows, which has hampered effective monetary control. The authorities are therefore right to focus their efforts on a significant tightening of financial policies--including a shift in the policy mix toward greater fiscal restraint.

Given the present conjuncture of macroeconomic developments, the reassessment of Sri Lanka's exchange rate policy is both timely and appropriate, and we support the staff's advice in this regard. The exchange rate should be allowed to play its role in controlling monetary expansion if the inflation objective is to be met. While the authorities' desire to move cautiously in this area is understandable, the staff is right to point to the inevitability of a real appreciation taking place. The question then is whether, from the perspective of a sound macroeconomic position, it would be preferable to yield to market pressures or accept a further increase in domestic inflation. Given the urgent need to reduce inflation to levels in line with those of trading partners, the latter option is one that, in our view, the authorities can ill afford.

According to the staff's latest projections, Sri Lanka's domestic and external prospects over the medium term are expected to be stronger than envisaged and offer the prospect of achieving rapid economic growth in an environment of low inflation and a balance of payments position that is sustainable. To realize these goals, it will be important that the authorities adhere to their reform agenda. Some of the measures will no doubt be difficult--namely, the additional improvements in the value-added tax structure, civil service reform, and the rationalization of the social welfare system--in the context of an economic recovery and the elections that are bound to heighten expectations. We hope that the authorities will reach understandings with the staff at the time of the midterm review on actions that will make up for past slippages in policy implementation and thereby establish the foundations for a lasting and durable improvement in the overall macroeconomic position.

Good progress continues to be made under the divestiture program, with further progress expected in 1994. Unless I missed a reference to it, I note that Sri Lanka's divestiture program has been carried out without an explicit social safety net. It is not clear how the authorities have coped with the difficult issue of labor displacement and the associated costs of training and redeployment, and some comment from the staff would be appreciated.

Finally, I commend the staff for the interesting set of background papers on recent economic developments, notably the analysis of productivity growth and a new look at the determinants of inflation in Sri Lanka. We support the proposed decision.

Mr. Dlamini made the following statement:

I am in general agreement with the staff analysis and policy recommendations, and will, therefore, limit my intervention to a few issues. The pursuit of more stringent financial policies is imperative if inflation is to be subdued. In this context, the authorities are encouraged to accord utmost priority to fiscal consolidation, which stands out as the hub of other financial measures designed to contain demand pressures in the economy. A reduction in government borrowing arising from lower deficit spending should facilitate the easing of interest rates and the redirection of available resources from the Government to the private sector. Moreover, the Central Bank's ability to control credit and the overall liquidity in the economy, including the element created through net foreign asset inflows, would be enhanced. The proposed fiscal strategy and the accompanying measures for achieving revenue enhancement and expenditure reduction seem to be appropriate. However, strict adherence to their implementation is critical to the achievement of positive results.

We are encouraged that the authorities are resolved to take compensatory measures if slippages occur to ensure that the program targets are met. The importance of accelerating the pace of implementing the structural program, including the ongoing tax and tariff reform, as well as the privatization and restructuring of public enterprises to generate expected budgetary savings, should be underlined. The effectiveness of monetary policy, no doubt, has been considerably weakened by fiscal slippages, among other factors. Indeed, the impact of sterilization and the tightening of credit to the private sector on the growth of monetary aggregates seemed to have been largely offset by the effect of the expansionary fiscal stance. In other words, net foreign asset flows have continued to be monetized through government spending of treasury bill proceeds, thereby fueling monetary expansion.

It appears that fiscal retrenchment, accompanied by a sterilization policy based on the Central Bank's own securities, should more effectively contain liquidity growth. I note from Mr. Fernando's statement the concern about the cost of issuing the Central Bank's own securities. I do not think that the erosion of profits should be of primary consideration to the Bank, bearing in mind that the benefits of achieving monetary stability for the economy cannot be quantified in monetary terms.

I would caution against the appreciation of the rupee. A modest appreciation as advised may be too small to make an impact, while a more substantial one could hurt the external sector, particularly the fast-growing non-oil traditional export sector. The authorities may wish to consider other policy options, some of which have been identified in the staff report. For example, while ensuring exchange rate stability, steps could be taken to create an appropriate environment for attracting foreign equity investments and non-interest-sensitive portfolio holdings. The efficiency of the stock market will be important in this regard.

Also, the mopping up of excess liquidity in the banking system could be facilitated through a discretionary increase in the reserve requirement. A phaseout of the Central Bank's concessional refinancing windows, through which substantial liquidity is currently being injected into the economy, is advised.

On financial sector reform, embracing the promotion of increased efficiency in the financial markets and greater competitiveness in the banking system is essential to the effectiveness of open market operations. Action in this regard should be expedited. Besides, the Government should consider divesting its equity interest in the banking system.

The medium- and long-term prospects for the Sri Lanka economy are bright but are predicated on the sustenance of the ongoing adjustment effort duly supported by concessional external financing. I support the proposed decision.

The staff representative from the Central Asia Department remarked that, with regard to a social safety net, the proceeds from privatization had been used to compensate those people who had been fired as a result of the process; to train workers for rehiring; and to restructure particular firms that had been privatized. In that way, resources had been used to help public enterprise workers become re-employed and not to fund wasteful spending.

During the privatization process in Sri Lanka, many workers had obtained shares in the companies and in that way had ensured their positions, the staff representative added. And following privatization, new owners, especially foreign firms, had been encouraged to retain and absorb the workers, thus minimizing the unemployment aspect of privatization. In that manner, the social safety net had been very effective.

On contingency measures to finance budgetary expenditures, the staff representative pointed out that civil service wages were capped, nonmilitary purchases of goods and services were frozen, and the risk related to capital expenditures was underspending rather than overspending. But one item might exceed the budgetary allocation: defense expenditures. The authorities had assured the staff that if the Ministry of Defense asked for additional expenditure, and the Government allowed it, there would be an increase in the defense levy; in that way the authorities would finance such additional spending.

As to Mr. Shaalan's question on exchange rate appreciation and competitiveness, the staff representative from the Central Asia Department explained that, assuming under his hypothesis a widening of the gap between investment and saving, the staff would look at ways to reduce investment and increase saving. Measures could include a cut in government investment, especially lower-priority items, and an increase in real interest rates, such that an increase in the nominal interest rate would be greater than that in the rate of inflation. Higher real interest rates could promote private saving. With respect to government saving, additional taxes could be introduced or other areas of current expenditures cut. Of course, in the case of Sri Lanka, it could prove difficult to cut expenditures further.

The staff representative from the Policy Development and Review Department suggested that, with respect to the hypothetical situation, the substantive alternative would be fiscal tightening and, of course, accelerated structural reforms to increase absorption of the resources.

Mr. Fernando stated that two clear messages had been given by Directors. First, they recognized the strong economic foundations of Sri Lanka, which would form the basis for increasingly stringent and sophisticated macroeconomic reforms--indeed, it would have been ironic if policies had been judged seriously deficient at the same time that Sri Lanka was accepting the obligations of Article VIII. Thus, Board approval of the third-year arrangement, in support of economic and financial policies to be followed in 1994, served to recognize Sri Lanka's achievements with respect to macroeconomic adjustment and structural reform. Mr. Ismael, for example, had considered the surge in capital inflows a vote of confidence.

It was noteworthy that throughout the period since 1989 when Fund-supported programs were in operation, beginning with the SAF and then the ESAF, the authorities of Sri Lanka had had to devote their attention to the political and security problems arising from the conflict in the north of the country, Mr. Fernando said. The policy guidance provided under the programs had been a source of strength that had allowed his authorities not to lose sight of fundamental economic objectives. Thus, the conflict had been marginalized in more than a territorial sense while the economic heartland had continued to benefit from the economic policies, and the results in terms of both growth and medium-term balance of payments viability were clear. Also, less than one year previously, economic policies had survived the assassination of the Head of State, providing further testimony to the underlying strength of the economy and the broad consensus for economic reform.

The second message concerned the several instances of delays in implementation, and a note of impatience had been detected in many Directors' comments, Mr. Fernando continued. Some of the postponements--for instance, with respect to the further reduction of the maximum tariff rate band--had been occasioned by the fact that previous reductions had had disastrous effects on revenue. Further, a substantial revenue decline had occurred on account of reductions in the corporate and personal tax. The delay in this instance had been inevitable. Even though wider economic criteria introduced some urgency for tariff reductions, the concern for continued macroeconomic stability, which was at risk through the original timetable for tariff reform, argued for some delay. He would also point out that 1994 was a presidential and parliamentary election year, and tariff reduction was a particularly sensitive topic that the Government had to handle carefully.

Indeed, in light of past slippages, the question had been raised as to whether the program could not have been deferred until after the election, with a type of enhanced surveillance covering the interim period, Mr. Fernando said. Despite the obvious difficulties and constraints related to a Fund-supported program, his authorities had decided that the discipline called for by an economic program was preferable; and political acceptance was more likely for a program supported by Fund resources, rather than for one of only enhanced surveillance. As to the balance of payments justification, the staff report cited continuing trade reform and the uncertainties associated with capital inflows as two important reasons for maintaining, or even strengthening, the existing level of reserves.

A main theme of the discussion was the economic and financial consequences of capital inflows, Mr. Fernando remarked. That phenomenon was associated with successful programs, particularly those supported by the Fund. The corrective actions required were not clear, although he would agree that one solution to the problems related to capital flows could be fiscal correction. Such action would allow the authorities to employ monetary policy instruments more effectively to control liquidity that was generated by domestic factors.

As to the extent to which fiscal policy could be employed in Sri Lanka, Mr. Fernando noted that the adjustment programs under the SAF and ESAF had assigned to fiscal policy the burden of achieving and maintaining macroeconomic stability. The first two programs had been marked by strong fiscal adjustment; that correction and the expectations thus created for macroeconomic stability should be seen as the initial basis for capital inflows. Fiscal adjustment had continued since then, although its pace and adequacy had been questioned. It was, however, noteworthy that the overall deficit for 1994, the third year of the enhanced structural adjustment arrangement, was still within the original target. The important issue to be addressed by the authorities was the extent of the burden to be placed on fiscal policy as an offset to the problem of capital inflows. It was not easy to attract public support for the additional fiscal adjustment required to compensate for capital inflows, and a real danger could arise that excessive use of fiscal policy for that purpose could provoke a backlash that would put at risk policies on a much broader front.

Within that constraint, his authorities had focused on expenditure restraint--particularly in view of further revenue losses as tariff reductions were implemented, Mr. Fernando continued. As programmed, the reduction in central government borrowing would reduce pressure on loanable funds. The Government, as Directors were aware, had pre-empted the long-term market for loans, but the 2 1/2 percentage point reduction in terms of the government borrowing requirement in loanable funds should lead to an easing of interest rates--the primary reason for capital inflows.

With fiscal policy actions in the short term strained to the limit, the issue was one of policy mix, Mr. Fernando stated. Implementation of monetary policy was difficult in Sri Lanka because, in using open market operations and treasury bills to mop up liquidity, the authorities had exhausted that short-term avenue. However, several other measures in the monetary area would reduce liquidity; for instance, the Central Bank would phase out its refinance facilities, strengthen its prudential supervision over commercial banks, thereby slowing down the accumulation of net foreign assets by the Bank, and take action to increase market determination of the exchange rate.

While Mr. Dlamini was correct in saying that the Central Bank, when issuing its own securities, should not be too concerned about the consequences for its profit and loss account in view of the larger gains, Mr. Fernando continued, he would mention that when actions were taken for a nominal appreciation of the exchange rate, the balance sheet would have to take into account not only the possible costs of sterilization operations, but also, considering that the Central Bank had been a large net purchaser of foreign exchange, the Bank's exposure to exchange losses as well. Moreover, when treasury bills were not adequate to mop up liquidity, it had to be decided to what extent the Central Bank could employ short-term instruments to do so without further increasing interest rates. In fact, it was argued that the treasury bill option was limited to the short term until such time as other instruments were developed. In that instance, if the Central Bank issued its own securities, their interest rate would have to be somewhat higher than that for treasury bills, simply because central bank securities, which were nonmarketable but transferable, had a premium over treasury bill rates. Thus, to increase attractiveness, an even higher interest rate was necessary, which could go in the wrong direction in terms of dampening capital inflows.

Nevertheless, his authorities recognized that a suitable policy mix tailored to the requirements of Sri Lanka might have to involve a nominal appreciation of the exchange rate, Mr. Fernando observed. Some movement in that direction was already noticeable, and the authorities would be vigilant in judging the latitude for change in the coming months. Moreover, trade reform, with regard to both tariffs and regulations, would provide some solution to the problem of capital inflows, while steady progress toward privatization would increase the efficiency with which capital inflows were absorbed.

He agreed fully with the comments by Mr. Posthumus on the need to reduce rigidities in the labor market, Mr. Fernando said. Admittedly, the Government might have moved in several areas, but it had been seriously hampered in doing so; nevertheless, he would try to provide Directors with a broader perspective on the problem, rather than offer excuses. A number of factors related not directly to labor flexibility but to labor compensation had complicated the authorities' agenda. For instance, a decision on pensions had been delayed; unfortunately, current budgetary constraints would not allow the authorities to make headway, bearing also in mind that the example provided by the outside world, in terms of pension policies and pay-as-you-go systems, did not encourage rapid implementation of the initial phase of pension reform. However, current actions were aimed at streamlining and restructuring labor benefits in terms of provident funds and retirement benefits. To that end, technical assistance had been provided by the World Bank, the ILO, and the UNDP.

The minimum wage was another difficult but important factor, Mr. Fernando added. Action in that area had been complicated by the wage and salary increases granted the previous year, but more fundamental problems existed. One was that in Sri Lanka, as in some other countries, there was a substantial mismatch between the educational opportunities provided to the labor force and the skills required by the emerging industries. Although slow progress was being made, the authorities still had to overcome difficulties in streamlining the educational and vocational training system in order to reduce the mismatch.

Another reason for the lack of increase in labor market flexibility was the wide regional disparities that prevailed in the country, Mr. Fernando continued. If health and educational facilities were better allocated throughout the country, labor would have less reason not to move. But unfortunately, regional development had been so lopsided that there was a tendency for labor to be concentrated in areas where housing, health, and educational benefits were better.

His authorities were aware that, given the serious fiscal constraints, they would have to improve their track record in implementing the value-added tax, Mr. Fernando remarked. For example, the nonstandard rate contained too many items that would have a negative impact on revenue, and the list of exemptions was simply a transfer of the current list applicable to the turnover tax to the value-added tax. The authorities knew that unless strong efforts were made toward ensuring revenue neutrality, what could be a milestone in structural reform could become a disaster. Continued technical assistance would provide the instruments and support required to work out a solution that would, at least in the beginning, be revenue neutral, and the authorities were ready to make the adjustments required to achieve that goal.

On the purchase of aircraft, which had affected negotiations for the second economic restructuring credit from the World Bank, the national airline in August 1991 had ordered five wide-bodied aircraft to replace its obsolete equipment, Mr. Fernando explained. The national airline was required to maintain its fleet because, as a result of the escalation of hostilities, several foreign airlines had stopped servicing Colombo; Air Lanka serviced the Middle East, where there was a large number of Sri Lanka workers, and Eastern and Western Europe, which was an important source of tourist traffic.

During the negotiations with the World Bank on the proposed credit, the Bank had legitimately questioned the airline's solvency and had raised the issue of whether the purchase would not interfere with the privatization prospects of Air Lanka, Mr. Fernando recalled. Thus, the authorities had undertaken an important exercise of route rationalization, as a result of which several destinations had been dropped and the airline's scope of operations had been reduced. In addition, even though the original purchase order had not allowed for cancellations, the authorities had reopened negotiations, pointing out the concerns--including those raised by the World Bank--related to the order, and they had been able to stop orders for two of the five aircraft without cancellation fees. Two aircraft, to which the World Bank had no objection, were already in the production stage, but the third was in the design stage, and a fee of about $28 million in progress payments had already been incurred. Cancellation of the third aircraft would involve forfeiture of that amount. The authorities had considered that loss unacceptable; for the national airline, which had been profitable to date, the $28 million write-off would have meant a considerable delay in returning to profitability. Against that background, it was decided that, for the time being, the negotiations with the World Bank for the economic recovery credit would be frozen. He would point out, however, that none of the policy measures forming the basis for the World Bank credit, or indeed for the requested ESAF arrangement, were in question; the authorities stood ready to make progress on all of them.

The Acting Chairman made the following summing up:

Executive Directors commended the progress made by Sri Lanka during the first two years of the arrangement under the enhanced structural adjustment facility; economic performance had improved in a number of areas important for its medium-term outlook. In particular, they noted the steady strengthening of growth, investment, and the external position, as well as the rapid expansion of nontraditional exports and the substantial capital inflows. Notwithstanding these indications of increased confidence in the Sri Lanka economy, Directors expressed concern over the difficulty in reducing inflation, the slippages in implementing fiscal policies, the limited success in containing monetary expansion in the face of the inflows, and the delays in introducing critical structural reforms.

Against this background, Directors stressed that, in the coming years, the authorities should redouble their efforts to bring about a substantial reduction in the rate of inflation, while maintaining growth and a viable external position. To this end, Directors were unanimous in calling for strong action on the fiscal side, directed at substantially reducing the overall deficit and augmenting government saving, in line with the program targets set under the ESAF arrangement.

On the revenue side, Directors supported the authorities' plans to further broaden the base, simplify the structure, and increase the elasticity of the tax system and urged them to redress the slippages in rationalizing the turnover tax system. Directors encouraged the authorities to enhance the revenue-raising capacity of the proposed value-added tax by limiting the number of items at the nonstandard rate and the number of exemptions, and they cautioned that possible short-run revenue losses from tax reforms should not be allowed to jeopardize the planned fiscal adjustment.

On the spending side, Directors underscored the need to maintain strict control over current expenditure as well as the importance of improving the overall structure of expenditures. They particularly stressed, in the context of defense spending, the importance of promptly undertaking corrective measures should overruns arise. Directors expressed disappointment at the lack of progress on public expenditure reform in view of its importance in securing a sustainable improvement in the fiscal position. Therefore, they strongly urged the authorities to move decisively and establish firm timetables for future implementation of civil service restructuring, social welfare program rationalization, and pension system reform. Directors welcomed the planned actions to enhance the quality and quantity of capital expenditure, including the pruning away of low-priority projects and the formulation of a core investment program, the latter in close consultation with the World Bank.

Directors noted that the large inflows of interest-sensitive and other capital were complicating the conduct of monetary policy. Reference was made to the experience of several other countries in the region enjoying capital inflows, and it was pointed out that, in those countries, such inflows provided an opportunity to accelerate macroeconomic adjustment and structural reform. Given the limited role that could be played by sterilization, Directors unanimously agreed that greater reliance on fiscal restraint was the appropriate policy response.

With respect to exchange rate policy, some Directors recommended a rate of depreciation that would be lower than the inflation rate in nominal effective terms. Other Directors recommended a more market-determined exchange rate system and expressed the view that this would help the authorities to reassert control over liquidity growth and contribute to a stronger anti-inflation policy.

Directors also emphasized the importance of complementing firm macroeconomic policies with far-reaching structural reforms. In particular, they regretted the absence from the Government's program of measures to reduce the prevalent labor market rigidities, in view of the persistent high levels of unemployment in the economy. In addition, they stressed the desirability of a restructuring of the public enterprise sector, especially in the plantations sector, and recommended a more vigorous program of privatization. At the same time, Directors regretted the slippages in financial sector reforms, the delays in improving the targeting of the social safety net, and the recent setbacks to trade liberalization stemming from the imposition of import surcharges and new duty waivers. They urged the authorities to correct these slippages and setbacks within the ESAF arrangement period. In this connection, they welcomed the renewed emphasis of the third-year program on trade and tariff reform, and they called on the authorities to carry out the remaining measures--including the further reduction in the maximum tariff rate--planned for 1994 in order to achieve the substantial progress envisaged in this area under the original ESAF-supported program.

Directors observed that Sri Lanka's prospects for the medium and long term were generally favorable, provided that the authorities implemented structural reforms vigorously and put in place firm macroeconomic policies supported by the ESAF. In particular, they agreed that the external position appeared to be sustainable on the basis of expected export growth, capital flows, and donor support. But Directors emphasized that the implementation of sound policies would be essential to maintain the confidence and support of the international community.

Directors welcomed the authorities' recent acceptance of the obligations of Article VIII.

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

The Executive Board then took the following decision:

1. The Government of Sri Lanka has requested the third annual arrangement under the enhanced 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 for Sri Lanka set forth in EBD/94/47.

3. The Fund approves the arrangement set forth in EBS/94/47, Supplement 2.

Decision No. 10635-(94/27), adopted
March 30, 1994

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/94/26 (3/28/94) and EBM/94/27 (3/30/94).

4. CAMBODIA - INCREASE IN QUOTA - GOVERNORS' VOTE

The Executive Board approves the report of the Secretary (EBD/94/25, Sup. 1, 3/29/94; and Cor. 1, 3/29/94) on the canvass of votes of the Governors on Resolution No. 49-1, with respect to the ad hoc quota increase for Cambodia, approved by the Executive Board (EBM/94/13, 2/22/94) for submission to the Board of Governors. The Governors' vote on the Resolution is recorded as follows:

Total affirmative votes	1,425,831
Total negative votes	0
Total votes cast	1,425,831
Abstentions recorded	0
Other replies	2,718
Total replies	1,428,549
Votes of members that did not reply	62,194
Total votes of members	1,490,743

Decision No. 10636-(94/27), adopted March 29, 1994

5. OFFICE SPACE - PHASE III - CONSTRUCTION BUDGET

The Executive Board adopts the proposal relating to the construction budget of Phase III, as set forth in EBAP/94/16 (3/15/94), Supplement 1 (3/22/94), and Supplement 2 (3/24/94).

Adopted March 29, 1994

6. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 93/111 and 93/112 are approved.

APPROVAL: December 1, 1994

LEO VAN HOUTVEN
Secretary