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Minutes of Executive Board Meeting 87/115

10:00 a.m., August 3, 1987

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
	J. A. K. Munthali, Temporary
Dai Q.	
C. H. Dallara	M. K. Bush
	H. S. Binay, Temporary
A. Donoso	
M. Finaish	A. M. Othman
	I. Zaidi, Temporary
G. Grosche	B. Goos
J. E. Ismael	
	J. Hospedales
	M. Foot
M. Massê	D. McCormack
	D. Saha, Temporary
Y. A. Nimatallah	I. A. Al-Assaf
	L. Filardo
	M. Fogelholm
	G. Pineau, Temporary
G. A. Posthumus	
	C.-Y. Lim
	B. Tamami
A. K. Sengupta	L. E. N. Fernando
	A. Vasudevan, Temporary
K. Yamazaki	
	R. Manfredi Selvaggi

L. Van Houtven, Secretary and Counsellor
J. K. Bungay, Assistant

Also Present
IBRD: S. T. Voyadzis, Latin America and the Caribbean Regional Office; L. Y. L. Yap, Europe, Middle East and North Africa Regional Office; N. Zagha, Asian Regional Department. African Department: L. Schmitz. Asian Department: H. Neiss, Deputy Director; W. Di, A. K. McGuirk, A. Singh, W. M. Tilakaratna. Exchange and Trade Relations Department: J. Hicklin, S. Kanesa-Thasan, T. Sasaki, N. E. Weerasinghe. External Relations Department: A. F. Mohammed, Director; S. Nawaz. Fiscal Affairs Department: K.-Y. Chu. Legal Department: J. K. Oh. Middle Eastern Department: P. Chabrier, Deputy Director; E. J. Bell, S. H. Hitti, H. E. Jakubiak, M. D. Knight, M. F. Melhem, A. Tahari, S. Thayanithy. Research Department: G. Hacche. Western Hemisphere Department: M. Caiola, Deputy Director; R. Arellano, D. L. Budhoo, L. A. Cardemil, E. Decarli, J. P. Guzman, M. E. Hardy. Bureau of Statistics: M. R. P. Salgado. Advisors to Executive Directors: M. B. Chatah, G. D. Hodgson, R. Morales, A. Ouanes, J. E. Zeas. Assistants to Executive Directors: O. S.-M. Bethel, E. C. Demaestri, G. K. Hodges, J. M. Jones, K.-H. Kleine, V. K. Malhotra, T. Morita, L. M. Piantini, A. Rieffel, S. Rouai, H. van der Burg, D. A. Woodward, Yang W.

1. JAMAICA - STAND-BY ARRANGEMENT - REVIEW AND MODIFICATION

The Executive Directors considered a staff paper on the first review under the 15-month stand-by arrangement with Jamaica approved on March 2, 1987 and a request for modification (EBS/87/152, 7/8/87).

Mr. Massé made the following statement:

The Executive Board has had numerous opportunities to review economic developments in Jamaica during recent years. On this occasion, it is heartening to observe the favorable trends now emerging within the Jamaican economy. As the staff paper notes, imbalances were substantially reduced during 1986/87, and economic growth is estimated to have recovered to 3 percent or higher. Increased nontraditional exports, strong tourism growth, larger than projected private capital inflows and a recovery in the volume of bauxite exports all contributed to expanded output and a stronger overall balance of payments. All quantitative performance criteria for end-March 1987 were met, albeit with narrow margins with respect to ceilings on net domestic assets of the Bank of Jamaica and on the central government net financing requirement.

Further, growth is now expected to continue in the 3 percent range for 1987/88, while inflation is projected to decline to about 5 percent. My Jamaican authorities are encouraged by all of these developments, and wish to reiterate their intention to persevere in creating the conditions for a sustainable balance of payments position and a solid growth path.

In light of these positive developments, only a few comments on policy and program design are required at this time.

After paring back public investment over a number of years, there is now a need for increased public capital expenditures, both to improve the economic infrastructure for tourism and the export base and to renew the development of social infrastructure. The sizable increase in budgeted capital expenditures needs to be put in context, since it takes place against a low base level of capital outlays. My authorities recognize, however, the constraints to a rapid increase in public investment. It is not their intention to place new pressures on the fiscal position, nor to replace private investment with public investment. Therefore, consistent with the original intent of the stand-by arrangement, increments in public investment outlays above those originally programmed will take place only to the extent that they can be financed by divestment proceeds from nondomestic sources, to ensure that there is no crowding-out of private credit.

My authorities are currently negotiating with ALCOA for the purchase of the Clarendon alumina refining plant. The World Bank has reviewed the proposed purchase, and finds it justified in terms of efficiency and profitability. Moreover, the purchase of the Clarendon plant would allow the Government to increase the plants alumina refining capacity, with net benefits to the Jamaican economy over the longer term. Under these circumstances, the proposed modification with respect to the ceiling on the overall public sector financing requirement is fully warranted.

To ensure that adequate support is given to the other components of the adjustment plan, monetary policy will have to continue to be carefully restrained. Interest rates are being maintained at their present levels for the time being, and technical adjustments are being made to the auction market for government securities to give greater transparency and consistency to interest rate policy. My authorities are, of course, concerned about the impact on capital formation of the high cost of credit, and are implementing measures to reduce bank spreads, with the help of the World Bank.

Incomes policy is another important element in the program. Although the decline of the U.S. dollar has helped to solidify Jamaican competitiveness, wage restraint must remain in place. My authorities are committed to the 10 percent wage guideline and are carefully monitoring developments in this area.

As a final remark, it should be emphasized that the proposed modifications to the program will strengthen the economic management capacity of my authorities, while contributing to a stronger growth environment over the medium term.

Mr. Hospedales made the following statement:

Jamaica's performance under the current stand-by arrangement has been altogether very satisfactory. All measures have been implemented as envisaged and all performance criteria through end-March 1987 have been observed. Supported by a reasonably favorable international environment--including lower prices of petroleum than before 1986 and somewhat lower international interest rates--the adjustment process is moving now into a new phase of recovery and growth, a long-sought objective both by Jamaica and major international institutions. This transition is being spurred by an expansion in tourism, in bauxite/aluminum exports, and in nontraditional exports.

Despite the highly satisfactory results of an improved economic performance, Jamaica's economic adjustment is not without significant problems, as the balance of payments remains fragile--a point emphasized by the staff in its well-balanced review. One of the conspicuous difficulties, in our view, has been the substantial decline in government capital expenditure in recent years. For this reason, the emphasis placed by the authorities on raising national savings levels and expanding capital formation is well conceived and understandable, especially in the context of the vulnerability of the Jamaican economy to external shocks.

Accordingly, the reduction of the public sector deficit and the renegotiation of external debt have been pivotal factors in the process of restoring financial discipline, generating national savings, and reigniting growth. Revenue performance and expenditure economies have been better than programmed and the authorities will be well advised to persevere in their efforts in this direction, including the promotion of the private sector in the development of the economy--the latter objective being actively supported by the current process of privatization. Nevertheless, we agree that the proposed foreign-financed buy-out of the alumina refining plant from its foreign owner is a correct decision in the light of the World Bank's assessment that the plant is efficient, profitable, and viable, and in view of the high cost that its closure would mean to the Jamaican economy in terms of output, employment, and foreign exchange. The proposed closure--an option dictated by the corporate strategy of its owner--underlines the need for the authorities to be conscious of the problems stemming from a reliance on international private capital that is inconsistent with the needs of Jamaica and the potential profitability of an enterprise itself.

The modification to the ceiling on the overall public sector deficit to accommodate the purchase of the plant strengthens the design of the program, which now focuses more sharply on growth aspects, as do the proposed mechanisms to provide for greater flexibility and caution in the management of capital expenditure--financed in part by divestment proceeds. This process will ensure that the buildup in capital expenditure to levels that prevailed in the early 1980s does not unduly strain the absorptive capacity of the economy. There is great merit, therefore, in utilizing part of the divestment proceeds to reduce the net domestic indebtedness of the public sector and, appropriately, additional capital expenditure is contingent on divestment proceeds being foreign generated; the use of short-term borrowing to offset temporary lags in the drawdown of project loans is in line with this general strategy. Accordingly, we can support the modifications to the relevant performance criteria stemming from these arrangements in order to preserve the internal consistency of the program.

The authorities must be alert to the need to avoid slippages in the implementation of these agreed macroeconomic and structural policies, and it will be of paramount importance that they stand firm in their resolve to do so. The larger than expected private capital inflows, net increase in international reserves, and increasing degree of business confidence are direct benefits of this adjustment effort, a key component of which has been the confidence-inducing effects associated with a coordinated policy of stable exchange rate pegging and wage restraint.

Nevertheless, Jamaica will need to rely over the next few years on exceptional balance of payments financing, in the form of debt relief and multilateral and bilateral support, to ensure that the growth momentum is sustained. Jamaica's adjustment experience suggests that countries with high levels of indebtedness can service their debt and otherwise reduce the burden it imposes on the economy only through the resumption of export-oriented economic growth; demand adjustment and recessionary policies are not acceptable or sustainable solutions from the economic, social, or political viewpoint.

Mrs. Filardo made the following statement:

It is encouraging to observe the substantial progress made by the Jamaican authorities in their economy during 1986 and their compliance with the performance criteria in the stand-by arrangement. As the staff report stresses, and Mr. Massé has emphasized, the internal and external imbalances have been reduced substantially, and there has been a significant recovery of the economy. A combination of factors has contributed to this development: the thoroughness with which the new Government has been implementing its economic program; a favorable external environment, such as the reduction in oil prices; the fall in interest rates; the significant improvement in the tourism sector; and the demand for Jamaica's bauxite and alumina.

In most areas of the economy important progress has been made: the current account deficit has been narrowed sharply from 12 percent of GDP to 4 percent of GDP; the net international reserves position has improved by $55 million; growth has resumed, with real GDP expanding at 3-4 percent in 1986-87 after an equivalent decline in the preceding year; the 12-month rate of inflation fell from 20 percent at the beginning of fiscal year 1986/87 to 8 percent at the end; and arrears were reduced as a result of a better balance of payments performance.

Despite this progress, the external position remains extremely vulnerable and Jamaica will continue to require financial support. During 1987 oil prices and interest rates have increased, and in spite of the improvement in bauxite/alumina exports and tourism receipts, the authorities have to emphasize nontraditional exports, which will require flexibility in the exchange rate policy. Jamaica's currency has been pegged to the

U.S. dollar since 1985, and although that system has helped to keep the real effective exchange rate under control until now, the authorities might have to overcome the natural temptation to avoid any modification of the system. For instance, the medium-term outlook projects that the current account balance will rest heavily on nontraditional exports and tourism, which will require the authorities to be committed to a more flexible exchange rate and a more restrictive incomes policy. Furthermore, the financial gaps that are projected until 1991 will have to be financed on an exceptional basis, for instance, by debt relief.

In this regard, we agree with the staff that fiscal discipline is crucial to maintain the program on track. While we recognize the importance of capital investment, it has to be put in the context of the internal and external availability of resources. Given Jamaica's limited possibilities of receiving new money from external sources and the vulnerability of the Central Bank to any changes in foreign interest rates, the authorities' recognition of this fact is encouraging, as is their commitment to finance the increased capital outlays by divestment proceeds without crowding out the private sector. It is thus important that the Government expeditiously accelerate the divestment program. In this respect, our chair supports the authorities' request to modify the performance criteria, as indicated in the proposed decision.

Jamaica's challenge ahead will be to strengthen the balance of payments while controlling the rate of inflation. To this end, a combination of sound financial policies, structural reforms, and a favorable external environment will be essential to enable Jamaica to follow a path of sustained and stable growth.

Mr. Goos made the following statement:

I congratulate the authorities for their substantial progress made thus far under the stand-by arrangement in virtually all areas that are critical to the restoration of a sustainable overall position. I am particularly impressed by the spectacular deceleration in the rate of inflation, which should go a long way toward improving the domestic environment for savings and investment.

At the same time, however, the excellent start of the program has not materially changed the difficult medium-term outlook, including Jamaica's rather fragile external position, and thus I hope that the recent adjustment gains will be consolidated further in the period ahead. While this seems to be the case for domestic price performance, I am somewhat worried about the interruption and, indeed, partial reversal of the adjustment progress envisaged in the external current account and the overall fiscal position, and I am particularly concerned about the deterioration in the underlying fiscal deficit projected for the fiscal year 1987/88. I appreciate of course that this development--at least in part--does reflect considered decisions of the authorities that have met with the approval of both the Fund and the World Bank staffs. Nevertheless, I am concerned that the renewed widening of the imbalances could give the wrong signals about the authorities' policy intentions, thereby fostering inflationary expectations. Such an outcome would be unfortunate, as it would complicate the critical task of containing domestic credit expansion, while at the same time allowing the exceptionally high real interest rates to decline to levels that are more conducive to investment.

These concerns are underlined by the very ambitious divestment/investment plans envisaged for this year. To be sure, the staff and the authorities have developed an ingenious, highly sophisticated solution for protecting the financial program targets, including adequate provision of credit to the private sector. But even allowing for the limitation that public investment expenditures can be increased beyond a certain level only if they are financed through the foreign proceeds of divestment, I still fear that the investment program, by its sheer size, could unduly strain the supply capacity of the economy. It therefore seems advisable--as a minimum--that the authorities carefully monitor the impact of their investment activity on economic developments, with a view to stretching the investment plan beyond 1987/88 if signs of strain should develop in domestic price performance and in imports. At any rate, I would strongly endorse the staff's emphasis on the need to achieve further reductions in the overall public sector deficit in the years ahead.

Other areas also require continuous attention, notably wage performance and external competitiveness. In this regard, I have nothing to add to what has been said by previous speakers and I will conclude by endorsing the staff appraisal and the proposed decisions. I might add that I am greatly encouraged by Mr. Massé's opening statement, which in general reflects a welcome responsiveness of his authorities to the concerns expressed by the staff.

Mr. Dallara said that it was encouraging to see the improvement in Jamaica's economic circumstances and prospects in the months since the approval of the stand-by arrangement (EBM/87/34, 3/2/87). The current account deficit had been reduced substantially and the net international reserves position had strengthened. In other areas, Jamaica's performance in the current fiscal year showed promise of exceeding the projections, with growth higher than expected and inflation, lower. In view of the Board's detailed discussion in March on the overall approach embodied in Jamaica's program, his comments would focus on a few specific areas rather than on the overall strategy.

A substantial amount of fiscal consolidation had taken place in 1986/87, Mr. Dallara observed, but he was concerned about two developments: first, the plans for quite a large increase in investment spending in 1987/88, to be financed by privatization proceeds. He wished to make it clear that he welcomed the authorities' privatization efforts, which had been accelerated and which he believed could benefit the economy, particularly over the medium term. However, those divestment revenues were likely to be one-time proceeds. The staff had pointed out that there were no net gains to the economy from those proceeds, and thus he wondered whether there was a potential need to support the operational and maintenance costs of the investments, many of which would probably become multiyear investments. In view of the one-time nature of the divestment proceeds and the likelihood that the investments would be made over a longer term, he would encourage the authorities to proceed cautiously in order to avoid a future situation in which a given level of government investment might be difficult to maintain.

The second development of concern was the authorities' plan to purchase the Clarendon alumina refinery from a foreign owner, Mr. Dallara continued. The staff and Mr. Massé had cited the World Bank's judgment of the profitability of the refinery as a basis for proceeding with the purchase; however, he would welcome additional information about the planned purchase. He wondered whether other investors had been sought, and if the alumina refinery was clearly a profitable enterprise, why the Government was the only possible purchaser. The planned purchase of the alumina refinery would cost 1.6 percent of GDP, which appeared to be relatively expensive, and thus additional details would be helpful. He had noted with interest the possibility that the World Bank would finance the foreign exchange cost of the transaction, and he wondered what the prospects were for such financing as well as the timing.

Those two developments had to be viewed in the context of the evaluation of the staff that the underlying fiscal position might be somewhat weaker in the current fiscal year than programmed, because of higher world aluminum prices and higher Bank of Jamaica losses that would more than offset some revenue improvements, Mr. Dallara indicated. The authorities had provided some reassurance by agreeing not to count all privatization proceeds as financing available for extra spending, but rather to use some of those funds to finance already planned expenditures. Nevertheless, he urged the authorities to take a cautious fiscal approach.

The issue of private sector investment led him to raise some questions on monetary policy, particularly on interest rate policies, Mr. Dallara went on. Jamaica's high real interest rates had encouraged foreign capital inflows and had clearly helped the balance of payments position. At the same time, domestic growth had increased somewhat. However, he wondered about the role of private investment in Jamaica--was the private sector bringing back flight capital, or was it borrowing abroad instead of borrowing domestically? The World Bank was directing assistance toward financial sector reforms aimed at reducing the high spreads between lending and deposit rates, which might eventually help. In the meantime, however, those high rates demonstrated some of the possible costs associated with the fixed exchange rate policy, including the implication that interest rate reductions might indeed require significantly tighter fiscal policies to protect the exchange rate.

The mechanisms designed to indicate a need for exchange rate adjustment had not come into play, given Jamaica's good inflation performance and higher net international reserves, Mr. Dallara commented. However, the authorities had to be prepared to address the exchange rate issue promptly if the need arose. In particular, while export and tourism growth had been improving recently, any weaker performance in those two areas could indicate a need for exchange rate action. In the meantime, the authorities should also adhere to their strict wage guidelines.

The fact that the exchange rate trigger mechanism had not come into play ought not to give the authorities undue comfort that the exchange rate was necessarily being used properly in its role as an economic tool, Mr. Dallara advised. In fact, he would have appreciated having more analysis by the staff, because the fact that the rate was within the limits of the trigger mechanism did not reassure him completely; at some point in the future the trigger mechanism might be seen as not acting early enough to indicate the need for exchange rate change.

Those were his principal concerns, which the staff had shared in its appraisal, Mr. Dallara concluded. Although he did have reservations about some of the approaches of the authorities, he could go along with the requested modifications to the program, all of which appeared reasonable. He was encouraged by the developments that had taken place in Jamaica because, in considering the rather difficult medium-term prospects, he recognized the need not only for a continuation of the beneficial exogenous developments, but also for strong, comprehensive domestic action so that Jamaica could move toward medium-term viability in its balance of payments position, while fostering growth in the economy.

Mr. Lim made the following statement:

> We welcome the improvement in Jamaica's economic performance over the past year and the news that Jamaica has met all the program's performance criteria as of end-March 1987.
>
> While this progress--including the strengthening of real GDP, the better than expected rate of inflation and balance of payments performance, and the improved finances of the overall public sector--owe much to favorable external factors, the authorities' own policy efforts have certainly made a contribution. It is an encouraging first step in Jamaica's adjustment effort after many years of mediocre economic performance. Against this background, it is disappointing that the authorities are not willing to take full advantage of the improved economic conditions to pursue vigorously further adjustment in 1987/88.

The staff paper leaves us with the feeling that instead, the authorities are content to mark time in the coming year in the area of fiscal policy. Two factors, in particular, contribute to this conclusion: the unequal treatment of the purchase of the Clarendon alumina refinery compared with the authorities' proposed divestment program, and the proposed increase in capital expenditure. We are being asked to approve an increase in the program targets for the public sector borrowing requirement and the overall public sector deficit to meet the costs of the refinery purchase. It is not proposed to treat the sale of a substantial number of government assets in a reciprocal fashion.

Restricting the increase in capital expenditure to what can be funded from the foreign exchange proceeds of the divestment program will, as the staff notes, prevent the capital expenditures program from crowding out domestic private sector investment. However, the proposed additional capital expenditures are likely to increase inflationary pressures and lead to a less favorable current account position and overall balance of payments outcome than in the absence of such expenditure.

We also have some concerns about the proposed purchase of the Clarendon refinery. We wonder why the private sector cannot run the plant if it is both profitable and efficient by world standards. In any case, if it is important that the authorities purchase the plant, we would have preferred its purchase to be financed from the foreign exchange proceeds of the divestment program rather than by an increase in the budget deficit. We have two other specific concerns with the fiscal program. First, the proposed increase in capital expenditures is to be financed by revenue earned from the sale of government assets. There is a significant risk that the level of capital expenditures envisaged by the authorities cannot be cut back once the one-time divestment revenues are used, thereby increasing pressures on the budget deficit. Moreover, the announced budgetary expenditures will do little to foster a return of confidence in the authorities' ability to reduce the deficit. This confidence will be important both for continuing domestic private investment and for private capital inflows. We would have preferred the authorities to use the opportunities offered by the improvement in the fiscal position and the proceeds of the proposed divestment program to consolidate further the recent improvement in the fiscal position. Such progress will be critical if the adjustment effort is to be sustained.

With regard to monetary policy, we welcome the emergence of positive real interest rates during the course of the past year. Given the rapid credit and money growth and the proposed budgetary stance for 1987/88, there is a need to proceed cautiously in reducing interest rates. The Bank of Jamaica losses will continue to be significant, reflecting the servicing of the stock of external debt held by the Bank. The interest payments from the Central Government to the Bank remain very modest; I would urge the authorities to move more quickly in rationalizing the financial operations of the Bank. In this context, I welcome the proposed financial reforms, including the intention of the authorities to increase the portion of commercial banks' cash reserves on which the Bank of Jamaica pays interest, and to eliminate the liquid assets requirement.

The significant strengthening of Jamaica's balance of payments position in 1986/87 was most welcome. Nevertheless, Jamaica's external position will remain vulnerable for several years. The lower inflation rate and wage settlements are encouraging in this regard. However, cautious monetary, fiscal, and wage policies will be essential to maintain the economy's competitiveness and to foster diversification into nontraditional exports. Finally, we support the proposed decision.

Mr. Foot expressed his strong agreement with Mr. Goos's words of praise and warning, as he had struck the right balance in recognizing the appropriate beginning that the authorities had made as well as the dangers that lay ahead. He also wished to echo the request made by Mr. Dallara and Mr. Lim for more information about why the interest in buying the Clarendon refinery was so limited, and for more information on the progress of the authorities' divestment program.

As Mr. Lim had indicated, there was a certain asymmetry in the way in which the staff was proposing that the receipts and costs of asset transactions were accounted for, Mr. Foot considered. While it was proposed that the ceiling on the public sector financing requirement be increased to reflect the costs of purchasing the Clarendon alumina refinery, there was no proposal to reduce the same ceiling to take account of foreign proceeds from asset sales. He could not help but note that the staff did not seem to have taken the approach in the current situation that had been taken during recent Article IV discussions with the United Kingdom, namely, that the proceeds of asset sales were best viewed as below the line items. He was not saying that one approach was necessarily better than the other, but there did seem to be a lack of consistency in the staff's approach, and staff comment would be helpful.

The staff had rightly stressed the need for continuing tight monetary policy and for a successful outcome to the forthcoming round of public sector wage negotiations, Mr. Foot commented. The authorities were clearly well aware of the importance of those points and more generally, of leaving room for the private sector to play its part. Much more needed to be done, but a worthwhile start had been made. Finally, he could support the proposed decision.

Mr. Al-Assaf made the following statement:

I too am quite encouraged by the significant progress made by the Jamaican authorities in reducing economic imbalances and by their success in reviving the pace of economic activity. I am especially heartened by the general improvement in business confidence and the favorable prospects for continued robust growth. The task now facing the authorities is to consolidate their gains, strengthen the private sector's confidence in the economy, and maintain the momentum of adjustment and growth. One must not, however, underestimate the difficulties ahead and the still delicate balance of payments position. Accordingly, I find the authorities' intentions with respect to the public investment plan a cause for concern. While I can see room for increasing public investment in the area of economic and social infrastructure, I am afraid that the Jamaican economy is not quite out of the woods. I am not sure, for example, that the envisaged boost in development spending is fully consistent with the authorities' efforts aimed at reducing the pressure on both the fiscal and balance of payments positions. Furthermore, embarking on an investment of the magnitude envisaged might reduce policy effectiveness in reducing the rate of inflation and containing costs, especially labor costs--two critical elements in safeguarding international competitiveness. It will also limit considerably the authorities' ability to accommodate higher than anticipated oil prices and interest rates in the coming year without compromising the program objectives.

It is for these reasons that I urge the authorities to exercise restraint in this area. Further, while I welcome their intention to accelerate the divestment program, it should be clear that the domestic proceeds from such divestment operations do not add to available resources. Therefore, any use of the proceeds for investment purposes would simply put more pressure on limited available resources, with serious inflationary and/or balance of payments implications. In this regard, I very much agree with the staff that the performance criterion relating to the definition of the financing requirement of the overall public sector should indeed be adjusted so as to reflect this constraint.

In conclusion, I commend the authorities for their strong showing last year, and I urge them, in the light of the still difficult balance of payments prospects, to persevere with their adjustment efforts. I endorse the proposed decision.

Mr. Posthumus stated his support for Jamaica's policies. It was indeed encouraging to see that the country had started on the road to adjustment. He also supported the staff appraisal and the proposed decision.

He did not have anything to add to what previous speakers had said, apart from an observation on Jamaica's exchange rate policy, which perhaps ought to have received more attention in the staff paper, Mr. Posthumus continued. That policy seemed to be essentially correct, and reflected efforts to emphasize internal economic adjustment, which was appropriate up to a limit. As long as exchange rate stability was maintained by a combination of internal adjustment policies, among which the staff had rightly pointed out incomes policy and maximum openness of the exchange rate market, then the authorities' approach to exchange rate policy was essentially right.

The staff representative from the Western Hemisphere Department commented that the concerns expressed by Directors--that the deterioration in the underlying fiscal deficit in 1987/88 might give a wrong signal, and that an easing of fiscal policy and an asymmetrical treatment of investment and divestment might pose problems--had also been of concern to the staff in its discussions with the authorities on how to treat those aspects of fiscal policy within the general thrust of the program. In fact, the deterioration in the fiscal ratios did reflect the provision for the purchase of the Clarendon alumina plant; otherwise, the underlying trend would have been downward.

The staff had accepted the authorities' arguments that the purchase of the Clarendon plant was a special transaction, and that because of a number of complicating factors, no other options were available, the staff representative continued. First, the plant was under a lease arrangement with the authorities that had made it too complicated for any other party to envisage such a purchase. Second, the trend in the international aluminum market was for large multinational companies to concentrate increasingly on fabrication and processing, and to decrease their involvement in extraction and medium-level processing, which meant that no other large companies were interested in buying the plant from AlCOA. Finally, the continued excess capacity in the aluminum industry reduced the demand for such a plant. At the same time, certain investments--for example, for improvements in the waste disposal system--were urgently needed to maintain and expand the operating capacity of the plant, and those investments were not likely to be made while the legal ownership of the plant remained uncertain. Accordingly, the staff had concurred with the authorities' judgment that the purchase was warranted and that the resulting fiscal effects would be temporary.

Like many Directors, the staff was concerned about how the authorities could sustain a high level of investment on the basis of one-time proceeds from asset sales, the staff representative remarked. Therefore, the staff had tried in the design of the program to ensure that the proceeds from those sales would be used to finance only investment, not current expenditures, and that the investment program would be oriented toward sustaining the export effort and toward infrastructure, particularly if it would help the tourism sector. The staff had relied heavily on the World Bank for that aspect of the program design, given its large input in the public sector investment program.

The divestment program was proceeding well, the staff representative said. Some shares in the telecommunications company had been sold to foreign investors. Foreign investors had also participated in the investment in the local cement plant in June 1987, and the total proceeds had reached J$140 million, of which J$120 million represented domestic subscribers.

When the program had been drawn up in March 1987, it had been envisaged that J$150 million in proceeds would be available from domestic resources, the staff representative added. According to the Government Finance Statistics manual, proceeds from divestment were considered revenue. The staff had adopted the practical approach of considering any proceeds above the J$150 million as financing, which could be used to reduce the overall deficit.

The staff considered Jamaica's high interest rates to have provided strong underlying support for the program in the past year, and felt that it would be risky to lower those rates until additional progress occurred in implementing the program, the staff representative indicated. In fact, only when the absorption of domestic savings by the public sector had decreased would it be possible to lower interest rates to a level that could sustain much more private sector investment; thus, the program had been emphasizing such a reduction in the absorption of domestic savings. It was very important to continue that process of fiscal improvement.

As to whether the exchange rate trigger mechanism within Jamaica's program was adequate, it was useful to recall that the mechanism provided a range in which policies could be managed without exchange rate action, the staff representative from the Western Hemisphere Department commented. However, there were ways of evaluating exchange rate policy, notably the net foreign assets test, which would come into play if the program targets were not met in a given quarter, and exchange rate action would then be one of the group of policy measures available to strengthen Jamaica's performance. The staff was not looking at relative prices alone, but was also interested in the underlying trends, which had recently been quite encouraging. Current account receipts from both tourism and nontraditional exports continued to do well. The number of tourists in May 1987 had been 21 percent higher than in the previous year, and the tourism sector was exceeding the performance assumptions that had been built into the program. All those factors needed to be kept in mind in any evaluation of exchange rate policy.

Mr. Massé said that his Jamaican authorities recognized that Jamaica had been in a very difficult situation for a number of years, which had created frictions with the Fund, and that when an agreement was finally reached between the Fund and the authorities it had involved quite a concession, and risks, for the Fund. Of course, the authorities were aware of the concerns raised by the staff and mentioned by some of the Directors, but they were also pleased to note that the progress that could be reported at the first review under the stand-by arrangement made it evident that the cooperation between the Fund and Jamaica was paying off for both parties.

The Executive Board then adopted the following decision:

Stand-By Arrangement - Review and Modification

1. Jamaica has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Jamaica (EBS/87/27, Sup. 3, 3/4/87) and paragraph 14 of the letter of December 31, 1986 (amended January 17, 1987 and February 26, 1987) from the Prime Minister and the Governor of the Bank of Jamaica, on the progress made in implementing the policies affecting demand management and the exchange system, in order to reach understandings subject to which Jamaica may make further purchases under the arrangement.

2. The letter dated June 19, 1987 with its attachment from the Prime Minister and the Governor of the Bank of Jamaica shall be attached to the stand-by arrangement for Jamaica, and the text of the Technical Memorandum of Understanding in Annex II to EBS/87/152 shall replace the earlier Technical Memorandum of Understanding attached to the letter of December 31, 1986, as amended.

3. Accordingly, the references in paragraph 4(a) and (b) of the stand-by arrangement to paragraphs 2, 3, 7, and 8 of the Technical Memorandum of Understanding attached to the letter of December 31, 1986, as amended, shall be read as references to paragraphs 2, 3, 7, and 8 as set forth in Annex II to EBS/87/152.

4. Paragraph 4(b)(i) of the stand-by arrangement for Jamaica shall be amended to read as follows:

> the limit on external payments arrears as described in paragraph 5 of the Technical Memorandum of Understanding in Annex II to EBS/87/152, except for external payments arrears arising from nonrescheduled obligations as described in EBS/87/152, Part II, Section 4, or,

5. The Fund decides that the first review contemplated in paragraph 4(d) of the stand-by arrangement is completed.

Decision No. 8667-(87/115), adopted
August 3, 1987

2. SRI LANKA - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Sri Lanka (SM/87/148, 7/2/87; Cor. 1, 7/27/87). They also had before them a background paper on recent economic developments in Sri Lanka (SM/87/165, 7/17/87; Cor. 1, 7/27/87).

Mr. Fernando made the following statement:

Economic development and policies

Sri Lanka's economic policy thrust in the recent past inevitably weakened on account of a sharp decline in the terms of trade, the lower than expected pickup in the world economy and increasing damage arising from the ethnic conflict. Toward end-1986, the worst drought since 1950 dealt further blows resulting in a lowering of the growth rate to 4.3 percent in 1986 and to an estimated 3 percent for 1987.

These adversities had an unfavorable impact on the authorities' adjustment policies, contributed to a worsening of the fiscal imbalance, and renewed strains on the balance of payments. The authorities are anxious to strengthen the adjustment effort and important steps were taken in the budget for 1987. They are aware that a stronger adjustment effort can be sustained only in a background of an optimal rate of growth, since that alone would provide the flexibility required for policy choices.

The authorities are in broad agreement with the staff analysis analysis of the developments in 1986. They are formulating policy responses to those developments within a medium-term framework of economic adjustment, and are discussing this framework with the staff of the Fund and Bank with a view to working out an arrangement under the structural adjustment facility.

Fiscal imbalance and prospects

The authorities share the staff's concern about the fiscal imbalance. At the previous Article IV consultation, concern was expressed at the degree of fiscal imbalance for 1985. The overall deficit was estimated at 14.3 percent of GDP. The final data, however, indicate a much lower deficit of 11.7 percent reflecting a higher level of nontax receipts and lower capital expenditures than the amounts estimated during the mission discussions. The disparity between the estimated and final figures, given Sri Lanka's record of currentness and comprehensiveness in compiling economic and financial data, have prompted the authorities to conduct a thorough review of fiscal reporting, accounting and monitoring systems, and they acknowledge the helpful guidance received from the Fund staff in this connection. They wish to restate their belief that good statistics are a prerequisite for good policy formulation and better monitoring.

Consistent with the Government's goal of a market-oriented economy and a large private sector contribution to economic activity, government expenditure as a ratio of GDP has been declining. This trend can be clearly seen if an adjustment is made for defense-related expenditures, which have escalated rapidly from 1.5 percent of GDP in 1983 to 6.2 percent in 1987 entirely on account of the ethnic conflict. Total expenditures thus adjusted would decline from 32.6 percent of GDP in 1983 to 29.1 percent in 1986 and to an estimated 26.4 percent in 1987. Consequently, the overall deficit would move from 8.9 percent of GDP in 1984 down to an estimated 5.7 percent in 1987, thus highlighting the authorities' success in restraining over that part of expenditures that are within government control.

A vital element of the authorities' commitment to sustained structural adjustment is the fiscal deficit reduction program, under which the deficit is to decline to a level that can be financed primarily by concessional foreign financing, leaving only a residual for domestic financing. Consistent with this objective, the budget for 1987 is targeted to contain the deficit to 10.4 percent--5.7 percent on an adjusted basis--as against 11.7 percent for 1986--adjusted, 6.6 percent--and present indications are that the program is on track.

Deficit reduction program

Public enterprise reform is expected to result in reduced claims on the budget. Transfers to public corporations accounted for 9 percent of GDP in 1986. Exception should be made, however, for some transfers, as they reflect financing of public investment for infrastructure development, such as the, Mahaweli Authority.

Increasing the efficiency in public enterprises inevitably involves the closure of unviable enterprises. In 1985/86, 12 public enterprises were closed down, and in 3 others, unprofitable product lines were closed. Significant staff reductions were achieved in some others. In view of the strong tradition of public ownership and control, the risk of social tension related to public enterprise reform is high, especially as the fear of unemployment is transparent in a country with no social security or unemployment insurance. Nevertheless my authorities plan to progress in this area with caution and pragmatism.

Another aspect is the dismantling of public sector monopolies. Banking, bus transport, and wholesale trade have been opened up for competition from the private sector with outstanding results, and insurance has recently been added to the list. In the coming period, this case-by-case approach will be supplemented through appropriate changes to the structure of import tariffs.

Government policy on privatization has been recently boosted by the appointment of the Presidential Commission on Privatization, composed of three high-ranking public officers and three eminent persons in the private sector. This Commission will carefully define policy, identify suitable candidates for privatization, and facilitate the actual transition.

The privatization of telecommunications and the highly profitable State Distilleries Corporation is already in progress. Another ten enterprises have been identified; some of them, such as the textile mills, are already under private management. This exercise is being facilitated by the World Bank.

While the authorities' commitment to privatization is on record, the momentum of reform is constrained by the relatively underdeveloped nature of the domestic capital market and the lack of a strong stock exchange. A Securities Council Bill which has just been enacted by Parliament, will serve to increase public confidence in and support for the development of the capital market, as well as strengthen the private sector through the institutional and other safeguards to facilitate orderly trading. Parallel to these actions, my authorities will keep under close review their policy with respect to private foreign investment, and to promote interest in such investment, they will liberalize further the rules governing areas with investment potential.

In regard to increasing the efficiency and productivity of the civil service, recruitment has been suspended and vacancies that arise are not being filled. In its interim reports to the Government, the Administrative Reforms Committee appointed in July 1986 has proposed a phased staff reduction program.

While overstaffing applies generally to the public sector, the considerable disparity that exists between public sector and private sector pay scales has posed major difficulties for the government efforts to attract and retain the services of qualified technical and managerial personnel. The previous revision of salaries dates back to 1981, and further restraint on wages was exercised when the cost of living compensation was frozen at its January 1985 level. In this background, and also partly because the Administrative Reform Committee required more time for a comprehensive formulation of its recommendations, the Government in mid-1986 restructured and simplified the salary structure in a manner that favored the most experienced staff.

In the area of fiscal accounting and expenditure control, a Fiscal Monitoring Unit has been set up in the Treasury to conduct quarterly reviews of government expenditure, ensure tighter control over cash releases, and facilitate a more comprehensive reporting of foreign assistance credits and grants. Highly experienced professionals have been retained by the Treasury to advise on systemic reform of the accounting and reporting system. The authorities emphasize that improving control and reporting is an ongoing, continuous process.

Capital expenditure restraint, given the resource constraint, will be facilitated by the completion of major elements in the Mahaweli program. With a view to protecting growth, the Government, with the assistance of the World Bank, will identify shortly a core investment program to protect priority and important ongoing projects while providing for adequate maintenance of capital stock.

While the authorities attach great importance to reaching the fiscal objectives, they are conscious of the possibility of defense expenditure overruns. Such an occasion arose early this year, and the Government responded with an across-the-board 11 percent cut on capital expenditures. Such generalized cuts, however, are harmful to growth. The core investment program, referred to earlier, is expected to minimize this risk.

With regard to increasing the resiliency of the tax system, the budget for 1987 has already reduced the production specific taxes in favor of value-based taxation of tea and coconut. Further progress in this area is envisaged. The authorities have demonstrated their commitment to tax reform by halting the grant of new tax holidays. In respect of both corporate and personal income taxes, the maximum marginal rate has been reduced to 50 percent with 40 percent for listed companies. Tax administration has also been considerably simplified. The number of income tax rate bands has been reduced from 11 to 5 and the turnover tax rate bands, from 10 to 6. Specific measures of structural reform to increase the efficiency of the tax and tariff system are being developed as detailed in the staff report.

Monetary policy evolution

In reviewing monetary aggregates, the authorities envisage keeping expansion within reasonable limits consistent with the reduction of the fiscal deficit. Thus far in 1987, the growth in monetary aggregates has conformed broadly with the annual target. Domestic credit rose 5.7 percent, with credit to the private sector showing strong growth of 7.9 percent as against 1.6 percent to the Government. The target of annual broad money growth, about 12 percent to end-1987, implies a price increase close to 9 percent. The drought-induced effect on the output of coconut, rice, and vegetables is expected to be felt more in the second half of 1987. The authorities are, however, firmly committed to keep broad money growth in check.

The authorities are facilitating greater market orientation in the determination of interest rates. The steps taken to expand the Treasury bill market are important. In late 1986, the Central Bank commenced weekly issues of Treasury bills, providing a ready outlet for liquid funds of commercial banks and other institutions. With a view to encouraging market forces to influence the yield on Treasury bills, commercial banks have been induced to participate in the primary market through a lowering of the yield on bills in the secondary market. Between January and June 1987, central bank holdings of Treasury bills declined from 81 percent to 64 percent. These developments provide vital underpinnings to the authorities' policy of progressive reliance on open market operations as a control instrument in place of more direct measures such as credit rationing and reserve requirements.

Balance of payments, exchange rate, and export promotion

In 1985/86 Sri Lanka suffered a terms of trade decline of 23 percent. The strain on the balance of payments within the framework of a liberalized trade and payments system was reflected in a sharp loss of reserves. In response to this adverse development, the authorities had to contend with further unforeseen hardships, arising from a drought-induced need for higher imports: rice, to meet a shortfall in domestic production, and oil, to provide thermal power to compensate for a shortfall in hydropower generation.

The authorities are confident that the imbalance will be gradually reduced as structural policy adjustment and demand management policies show results. The changing composition of public sector investment will provide a further impetus in this area: partly on account of the completion of major elements of the Mahaweli program, the import content of investment declined from 29 percent in 1984 to 23 percent in 1986.

The rapid rise in the debt service ratio from 19 percent in 1985 to 26 percent in 1987 has prompted the authorities to impose strict limitations on commercial borrowing. Commercial debt has declined from 27 percent of total outstanding at end-1985 to 24 percent at end-1986. The maturity profile of commercial debt has also improved: debt in the maturity periods of 15 years and over rose to 81 percent at end-1986 from 67 percent at end-1983.

The authorities' resolve to pursue a flexible exchange rate policy has already resulted in a real effective depreciation over 1985 and 1986 sufficient virtually to cancel out the appreciation over the period 1980-84. In managing the exchange rate, the authorities will pay due regard to underlying trends in domestic costs and prices so as to preserve competitiveness in conditions of orderly trading. To assess the direction and adequacy of movements, a mix of indicators and judgmental considerations will be employed. A flexible exchange rate policy will be a key element in the incentives structure to further diversify exports. The authorities firmly believe, however, that export promotion should encompass a wider spectrum of measures to supplement the exchange rate incentive. New projects, new products, and the entry into the export market entail much risk and uncertainty. An improved incentive structure is essential to overcome these obstacles.

The Government's acceptance of the recommendations of the Industrial Policy Committee Report will provide over time strong support for export diversification. Under the next stage of tariff reform, and in consultation with the World Bank, rates of effective protection will be reviewed to ensure that only potentially viable

viable units are assisted. In this context, the authorities regret the continuation of protectionist barriers in foreign markets. The very existence of such barriers introduces an element of uncertainty that makes investment decisions difficult and product planning most complex. Evidence of this fact is provided by the garment industry of Sri Lanka, which grew 12-fold from 1978 to 1984, but has shown little growth during the past two years.

In conclusion, Sri Lanka has been moving over a broad front of structural reforms of the economy, to achieve sustained growth and a viable balance of payments with increasing private sector partic ipation. Progress has at times veered from the intended path largely on account of persistent underperformance of the world economy and depressed prices for primary products. The authorities are committed to the policy reforms heralded by the budget for 1987 and further developed since then. However, given Sri Lanka's continuing vulnerability to exogenous factors, such as terms of trade, monsoons, and ethnic conflict, the authorities recognize a need for flexibility in implementing the reform package so as not to jeopardize the basic thrust of policy reforms. The authorities will continuously evaluate developments so as to judge as accurately as possible the timing of specific measures within an agreed program.

Extending his remarks, Mr. Fernando said that an important development had occurred on July 29, when the President of Sri Lanka and the Prime Minister of India signed the Indo-Sri Lanka agreement to establish peace and normalcy in Sri Lanka. Under that agreement, the hostilities arising from the ethnic conflict were to cease. The signing of that agreement had been an important step because the past four years of ethnic conflict has resulted in enormous damage to property and business confidence, had contributed to the deterioration of the fiscal imbalance, and had taxed the time and resources of his authorities as they attempted to reach a political settlement.

The implementation of the agreement had commenced immediately, Mr. Fernando went on. At the request of the Government of Sri Lanka, the Government of India had sent a peacekeeping force to secure the regions where hostilities were continuing. Furthermore, the elections to the Provincial Council were due before the end of the year. It was the expectation of his authorities that peace, law, and order would be restored soon. The strengthening of the new stability would provide a strong basis for confidence and the readjustment of policies, a point that had been emphasized at the Board discussion of the 1986 Article IV consultation with Sri Lanka (EBM/86/109 and EBM/86/110, 7/7/86). At the meeting of the Consultative Group convened by the World Bank in June 1987, much emphasis had been placed on the urgent need for a negotiated political settlement. Participants in that meeting had also expressed their willingness to assist in the rehabilitation of the economy after the political conflict had been brought to an end. His authorities were confident that the international community would support and facilitate that restoration process.

Mr. Foot recalled that Sri Lanka had been known in eighteenth-century Europe as the island of Serendip, from which the word serendipity was derived. One could only hope that serendipity would soon return to Sri Lanka. A general resumption of civil order would enable the authorities to focus all their energies on the fundamental economic problems facing them. Such a shift in attention was desperately needed. Even without the burden of higher security-related expenditure and the worsening of the terms of trade, there would have been a serious deterioration in the economy, stemming principally from further weakening in budgetary performance and from structural weaknesses in production and trade. The staff report had assessed those problems fairly and fully, and had left the impression that, as far as the authorities were concerned, many of the vital policy responses were still in the process of formulation, under consideration, or planned for the future. However, the tone of Mr. Fernando's statement was much more encouraging, and he hoped that the authorities had indeed refocused their energies on the matters at hand. Major slippages in policy had occurred in 1985 and 1986, and urgent further action was needed on central issues, such as budget subsidies and transfers and overstaffing in the civil service, before inflation picked up and the current account deficit became truly unsustainable because of the collapse of reserves. At present, the sizable aid assistance that the international community continued to offer was increasingly inadequate to cover Sri Lanka's growing imbalances. Moreover, aid inflows were expected to decline as major projects were completed and loan repayments began to increase. The compression of the public investment program was clearly a short-term expedient, and he was concerned that Sri Lanka would not be able to generate sufficient local counterpart funds to allow even a much reduced aid program to function smoothly.

The only sustainable solution was a comprehensive, fundamental program of adjustment, Mr. Foot concluded. Even while uncertainty continued with regard to the domestic security position, something could be done by way of restoring and enforcing adequate budgetary controls. The Fund could clearly have a central role to play in the future adjustment of Sri Lanka, although he would be reluctant to specify what that role might be. Given the importance of structural adjustment, a program funded under the structural adjustment facility could be a central aspect of Sri Lanka's adjustment plans. What was needed first, however, was further evidence that Sri Lanka had indeed put in place both the policies and controls needed to ensure adequate economic adjustment.

Mr. Ismael made the following statement:

> I generally agree with the staff's assessment of the Sri Lanka economy, and I share its concern about the present level of the current account deficit. At 9 percent of GNP, the deficit indeed appears to be unsustainable, given the limited scope for further increases in external financing. I can also agree with the staff's reservation about the key macroeconomic objectives contained in the medium-term scenario projected by the authorities.

The several risk factors cited by the staff are, in my opinion, realistic and cannot be ignored. Therefore, it is imperative that a much stronger adjustment effort be made by the authorities to avoid the unpleasant consequence of a forced adjustment, in the event that the flow of external financing is insufficient to finance the deficit.

In many years, the fiscal deficit has been the major source of domestic imbalance. I am pleased to note that the authorities have recognized this problem and have taken steps to reduce the deficit of the Government as well as that of the public enterprises. In the past few years, the public sector has been the fastest growing sector and has helped to sustain the growth of the economy when external demand slackened. The use of the public sector to stimulate the economy is neither sustainable nor advisable. While I recognize the social tension that would arise as a result of any major manpower reduction of the public sector, the present effort to contain the growth of this sector should be strengthened. Only through a reduction in the size of the public sector and, therefore, an increase in its productivity, can the remuneration gap between the public and private sectors be trimmed without further straining the budget.

The staff has rightly pointed out that the public enterprises, which control a large proportion of total resources, are frequently managed on the basis of noneconomic criteria and are a significant drain on budget resources. The inability of these enterprises to repay foreign borrowings through their foreign currency earnings has also adversely affected the balance of payments account. While a good start has been made in the monitoring and controlling of the public enterprises, the authorities should take further measures to subject them to economic principles.

I welcome the industrial and trade measures and the flexible exchange rate policy undertaken by the authorities aimed at developing international competitiveness in the industrial sector. However, realizing the benefits from these policy actions will take a long time. The immediate concern, therefore, should be focused on the reduction of the fiscal deficit. In this respect, I am glad to note that the security problem, which has contributed to the large budget deficit through increased defense expenditures, has finally come close to a solution. It is my hope that with the possible relief of this pressure on the budget, the authorities and the staff will soon be in a position to formulate a satisfactory economic policy framework for Sri Lanka's application for funding under the structural adjustment facility. Finally, I support the proposed decision.

Mr. Dai made the following statement:

The Sri Lanka economy has been strained severely by the sharp decline in the terms of trade and the weak demand for its exports. The continuing ethnic conflict and recent drought also have added greatly to the economic hardship. These unfavorable conditions have resulted in the twin imbalances in the budget and the trade account. Consequently, output growth slowed and inflationary pressures intensified. Faced with these enormous difficulties, the authorities have taken some important measures to redress the economy. The policies have led to a rise in nontraditional exports, an increasing resiliency of the tax system, and greater market orientation in the banking system. More important, government expenditure as a ratio of GDP has been declining, and the overall fiscal deficit is expected to decrease from 11.7 percent of GDP in 1986 to 10.4 percent in 1987. Also under way are measures to improve the efficiency of the public enterprises. At present, the formulation of an adjustment program to achieve effective control over public expenditure and the trade deficit has become the Government's first priority of economic management, and a timetable has already been set for further trade liberalization. In short, the authorities have made tremendous efforts to deal with the difficult situation, although it may take time to produce the desired effects.

Reducing the overall budgetary deficit is a policy priority, yet excessive cutbacks in investment expenditures may have negative effects on growth. For this reason, the authorities are contemplating a core investment program that would maintain existing assets, permit the completion of essential ongoing projects, and avoid compression of the core investments. I would support such a policy initiative.

Sri Lanka's export performance is a matter of vital importance to the economy. With a narrow export base, the country is extremely vulnerable to external developments, and, therefore, it is imperative for the authorities to diversify the export sector. In this regard, I agree with the authorities that export promotion should encompass a wider spectrum of measures to supplement exchange rate incentives. I am delighted to note that the nontraditional exports are developing rapidly. The authorities are well advised to keep such a momentum.

It is expected that Sri Lanka's balance of payments imbalance will be reduced gradually as the structural adjustment program unfolds. At this critical juncture in the country's circumstances, the Fund's financial assistance is of crucial importance. Therefore, I hope that, on the basis of the formulation of an economic and financial program in the coming months, with the help of the Fund and the World Bank, Sri Lanka's adjustment efforts will be supported through the Fund's structural adjustment facility. In concluding, I support the proposed decision.

Mr. Goos made the following statement:

The basic problems facing the Sri Lanka economy today seem to be largely identical with those identified at the 1986 Article IV consultation (EBM/86/109 and EBM/86/110, 7/7/86). In saying this, I do not want to imply that nothing has been done since then to move toward adjustment. On the contrary, I fully recognize the progress achieved in reducing the external imbalances and in containing the rise in the fiscal deficit--and those achievements need to be seen in the light of exceptionally adverse exogenous factors, including the drought of 1986, and above all the protracted ethnic conflict. Like Mr. Foot, I do hope that that conflict will be settled before long, which would improve radically the economic picture. Mr. Fernando has made a compelling case in demonstrating the underlying fiscal adjustment that has taken place over the recent years, including 1986, if one disregards defense-related expenditures. Nonetheless, I share the staff's concern that more needs to be done in order to prevent a destabilization of the economy. This concern is highlighted by the projected acceleration in the inflation rate and even more so by the rapid deterioration in the foreign reserve position and debt-related indicators.

Against this background I welcome the authorities' efforts to develop a comprehensive policy framework and adjustment program that could form the basis for assistance under the structural adjustment facility. As to the objectives and specific content of such a framework and program, I feel that the authorities' intentions--as outlined by the staff and Mr. Fernando--generally point in the right direction. This applies in particular to the intention to improve domestic resource allocation through structural reform in the public sector and the reduction of its overall role in the economy. Without going into detail, I would encourage the authorities to tackle the problems in these and related areas as a matter of urgency. I appreciate Mr. Fernando's concerns about the risk of social tensions as well as the need for flexibility in implementing the reform package in view of Sri Lanka's external vulnerability. However, these concerns have to be weighed against the serious external financing constraints, the authorities' growth objectives, and the need to inspire confidence in their adjustment strategy. Inasmuch as Mr. Fernando relates his social concerns to the lack of a social security and unemployment insurance system, I wonder whether the authorities could address this problem by establishing exactly such a system--which in general would also facilitate the transformation of the existing economy into a dynamic market-oriented enterprise.

The need for forceful and timely action both on the structural and macroeconomic fronts is also reinforced by the medium-term projections presented in the paper and in particular by the staff's sensitivity analysis. In view of the high sensitivity of the balance of payments projections to changes in important assumptions, I feel that the authorities should--to the extent possible--aim at more ambitious adjustment targets than envisaged under the medium-term scenario. At any rate, one can hardly overemphasize the critical role of policies to strengthen nontraditional exports and improve the domestic supply situation. In conclusion, I support the staff appraisal and the proposed decision.

Mr. McCormack made the following statement:

The Sri Lanka economy in recent years has been beset with difficulties. The terms of trade have deteriorated substantially. Agricultural production has been affected seriously by drought. Over and above these factors, however, has been the pervasive impact of the tragic ethnic conflict in Sri Lanka. Budgetary planning has been upset by the need to increase military spending, confidence has been seriously damaged, with notably adverse implications for the once booming tourist industry. We hope that the recent developments will lead to an early end to this conflict so that the Sri Lanka authorities can more effectively tackle the immediate difficulties confronting them, and put the economy back on a path of rapid economic development for the benefit of all the people of the island.

The combined impact of all the above factors has been to create clearly unsustainable internal and external imbalances. However, they have also exposed serious structural weaknesses in the economy that call for prompt and decisive action.

The staff appraisal indicates that domestic policies have been slow to adjust to the deteriorating economic conditions. It is quite clear how one could justify such a conclusion. However, one can well understand why, in such difficult circumstances, the authorities should hesitate about taking certain measures with far-reaching social implications, and which perhaps would risk adding further elements of instability to an already volatile situation. I do not believe that there is much point in dwelling unduly on the record of policy implementation in the recent past, as it is not likely to be a reliable guide for the future. If one looks to the future, the situation seems more promising. The staff appraisal and Mr. Fernando's detailed and encouraging statement make it clear that there is a wide measure of agreement about the diagnosis of Sri Lanka's economic difficulties. Moreover, there is a wide measure of agreement about the required prescription, although there may be some disagreement as to the precise dosages. I would join other speakers in urging the authorities to take early and decisive action in the context of a comprehensive program that could be supported by the Fund under the structural adjustment facility.

Thoroughgoing reform is required in a number of areas. Two seem to require particular attention, namely, the public finances, and the structure of incentives to be put in place and maintained in order to promote competitive export and import-substitution industries. A number of weaknesses can be identified in public sector finances. First, the domestic tax base is extremely narrow, given that 50 percent of revenues originate from a handful of commodities and that there are many tax exemptions and tax holidays. The authorities plan to formulate a new tax reform package designed to broaden the tax base and I would encourage them to do so with all due speed. It would be most helpful if the authorities could realize their intention of including in the 1988 budget speech a specific timetable for the implementation of the various tax measures that are envisaged.

On the expenditure side, the need to accommodate enlarged security-related spending has put pressure on investment expenditure. While the authorities may be able to compensate for this to some extent by improving the quality of investment, over the long haul such compression of investment must be detrimental to the growth of the economy. The authorities are to be encouraged in their efforts to identify a core program of priority investments. With respect to current expenditure, there are two key requirements: determined efforts must be made to curb transfers and subsidies and to reduce the public sector wage bill. I can understand the factors that led to the increase in the wage bill last year, in association with the restructuring of salaries. A restructuring along these lines, judged purely on its own merits, was clearly a desirable objective, as it appears that at the higher pay scales there was an undue degree of compression of differentials between the public and private sectors, with adverse effects on the Government's ability to recruit and retain qualified personnel. However, the resulting increase of some 17 percent at a time of overall fiscal stringency did seem excessive. Again, there must be a serious effort to reduce in the long term the actual numbers in the public sector, which is unquestionably overmanned. Given the social implications, however, it may be unrealistic to expect any significant reduction in numbers in the short term. Nonetheless, the authorities should insist all the more on maintaining their hiring freeze and allowing numbers to decline gradually through attrition.

The third area that calls for major efforts is the program of public enterprise reform, including divestiture and privatization. Despite my sympathy for the authorities concerning their difficulty in reducing numbers in the Central Government, I feel that to implement public enterprise reform one has to accept the necessity for closures. If I may take slight issue with Mr. Fernando, I think that the process will grind to a halt unless the need for closing uneconomic enterprises is accepted and a determined effort is made to spell out to the public why this is necessary, at the same time that every effort is made to ensure that workers released from such enterprises are brought into productive employment elsewhere. The point is that resources are constrained in Sri Lanka and they must be put to the most efficient use possible. This point was recently made very strongly by the Managing Director in his July 27 address to the United Nations Conference on Trade and Development in Geneva.

Because of the small domestic market, it will be essential to expand the export base to lessen the balance of payments problem, while allowing for sustainable economic growth. I am encouraged to note that the authorities intend to use exchange rate policy more actively than in the past in order to strengthen Sri Lanka's competitive position. The authorities are also considering changes in industrial policies aimed at improving the efficiency of the manufacturing sector and increasing export orientation through changes in the tariff system and enhanced export incentives. I welcome the efforts to simplify and reform the tariff structure and to reduce the dispersion of effective rates of protection. While applauding the authorities' efforts to remove the remaining export restrictions, I share the concerns of the staff concerning an expansion of fiscal incentives to exporters; these incentives may be administratively costly and difficult to implement, but in addition, when priority has to be given to enhancing the tax base, I feel that such an approach should be pursued very cautiously indeed. I share the staff's emphasis on the active use of the exchange rate instrument rather than on selective incentives.

My final point is to reinforce the staff's cautionary note that growth prospects in the near term could be less satisfactory than expected by the authorities because of lags in the response of the private sector to the various measures envisaged. I have expressed a degree of understanding about the social and political factors that argue for caution in certain sensitive areas, but I would like to balance that statement by stressing that delay or inaction also has its dangers. In their own interests, the authorities should try to bring forward as many elements of their program as possible and implement them vigorously.

Mr. Lim made the following statement:

As Mr. Fernando has indicated, his authorities are in agreement with the staff appraisal on developments and prospects in

Sri Lanka. Like the staff, I also commend the authorities for moving toward more market-determined interest rates through progressive reliance on open market operations. It is also encouraging to note that the pursuit of a flexible exchange rate policy has already enabled Sri Lanka to regain its previous competitiveness and that the authorities consider this flexible stance a key element in their efforts to expand the export base.

I agree with the staff that continuous cutbacks in development expenditures may be counterproductive, especially for this small developing economy where the impact on net economic welfare of government spending on basic infrastructure support is more than marginal. I also agree that there appears to be more than ample room for improving the efficiency of the civil service and further reducing government subsidies and transfers. Indeed, Mr. Fernando has pointed out that were it not for the increase in defense-related expenditures, the statistics would bear out the serious efforts of the Government to reduce the fiscal imbalance. We certainly hope that the ethnic conflict in Sri Lanka will be resolved as soon as possible to allow the authorities to proceed with their adjustment efforts.

On structural reform, there may be scope for accelerating the efforts at privatization, as this is invariably linked to the present difficulty in reducing the public sector deficit. We may point out that the carrying cost of inefficient public enterprises increases as the authorities allow the market to determine the prices of financial resources. It can also be argued that private sector initiative can be stymied by the presence of government monopolies and privileged competition. We are therefore heartened to note that the privatization of telecommunications and the State Distilleries Corporation is already in progress. However, as Mr. Fernando has indicated, institutional rigidities and the absence of a developed capital market and a strong stock exchange prevent a stronger private sector response. We would therefore call on the authorities to encourage inflows of foreign capital and to provide incentives for long-term investments in support of its privatization efforts.

Finally, we support the proposed decision.

Mr. Munthali made the following statement:

In recent years, Sri Lanka enjoyed an impressive rate of economic growth that averaged about 5 percent between 1982 and 1985. The rate of inflation was drastically reduced from its 1980 peak. As a consequence, per capita income increased and the economy experienced overall improvement. Other social and economic indicators give the impression that Sri Lanka has been improving the standard of living. For example, life expectancy compares favorably with that of other countries in the region. The ratio of physicians to the population is much more favorable than that of other low-income countries, and the adult literacy rate has improved significantly since the 1970s.

In 1986, however, the financial and economic situation worsened as growth slackened somewhat. This reflected in part the deterioration in the country's terms of trade and the effect of the severe drought that hit the country and adversely affected agricultural production. At the same time, the need to strengthen the internal security situation has not only weakened the Government's financial position but also has led to severe cutbacks in investment spending that were instituted to contain the overall growth of expenditure. Meanwhile, this fiscal expansion has been accompanied by an accommodating monetary policy and contributed to a resurgence of inflationary pressures, with the rate of inflation now estimated to reach 10 percent at the end of 1987. The external sector has also come under renewed pressure, and gross external reserves are expected to fall to slightly less than a month of imports. The external debt service ratio has also risen.

The authorities realize that the situation could worsen if appropriate steps are not taken to reverse this deteriorating trend. It is, therefore, encouraging to learn from Mr. Fernando that they have chosen to address these problems in the medium-term context. They have our full support. Indeed, I find Sri Lanka to be a good candidate for support under the structural adjustment facility; this is one country where success could be recorded, barring, of course, the problems arising from the civil strife. To that end, I am also pleased to note that the authorities have already isolated the structural issues that need to be tackled in order to put the economy back on the path of sustained growth. As I am in broad agreement with the general direction of policies enunciated by the authorities, I would only encourage them to start earnestly articulating the specific policy actions under the program. In that connection, I should like to emphasize that Sri Lanka has the potential to achieve a high rate of growth; I look forward to seeing that the program underpins the 5 percent average growth rate projected for the medium term.

However, this level of growth could be jeopardized if the authorities continue to rely on reducing investment expenditure in order to accommodate military expenses. Like the staff, I encourage the authorities to strike a better balance in their expenditure cuts and to emphasize those areas that do not impinge on the country's productive capacity. Perhaps consideration should be focused on minimizing subsidies and transfers.

Finally, I hope that the peace initiatives reported by the press, and corroborated by Mr. Fernando, will culminate in some tangible results that could lead to a final resolution of the problem, thereby giving the authorities the chance to focus on the economic issues.

Ms. Bush made the following statement:

At the time of the 1986 Article IV consultation, Mr. Dallara commented on the medium-term prospects for Sri Lanka. Specifically, he suggested that the recent growth and inflation performance, although very much in the right direction, might not be sustainable over the medium term without strong action to address existing and potentially large domestic financial imbalances and structural weaknesses in the economy. We see now, from the staff report, that after four years of steady growth at 5 percent each year, growth has begun to slow and the rate of inflation has begun to rise. While these developments have been influenced by exogenous developments, they re-emphasize the need for prompt action to address the financial imbalances and structural weaknesses.

About ten years ago, the Sri Lanka strategy shifted to one that emphasized market-oriented economic policies. While the authorities continue to emphasize those policies, and while their experience with such policies has been good, I am left with some discomfort about their level of success in reducing the intrusion of the public sector in the economy.

On both the need for prompt action to address financial imbalances and structural problems, and the still large public sector, I welcome the indications by Mr. Fernando that steps are being taken to deal with these problems. The detailed descriptions of fiscal and structural reform indicate that the authorities recognize the risk of not addressing these issues fully, and that they are taking steps to address them and to augment the prospects for good performance in the medium term.

More specifically, the wide-ranging public enterprise reform that has been under way, along with the plans for privatization, are important means of reducing the intrusion of the public sector. Certainly, bold action in these areas is called for in order to ensure the planned privatization and closure of unviable enterprises. I hope the authorities will not waiver on these essential actions. Mr. Fernando refers to the underdeveloped nature of the capital market and the lack of a strong stock exchange as constraints on privatization. We do urge the authorities to take all necessary action, including the use of Fund and World Bank expertise, in further developing the capital markets. Any constraints on privatization should be dealt with promptly, as privatization is important to the authorities' goals of augmenting the market orientation of the economy. It is also important that the Administrative Reform Committee has been appointed in order to establish control of, and reduce, overstaffing in the public sector.

The specific reforms of the public enterprises and staffing of the public sector are all most welcome and in the right direction; however, the timing of some of the planned actions is not entirely clear. I urge the authorities to take action in these areas forthwith, because prompt and continued action is essential to medium-term sustainable growth in Sri Lanka.

Care needs to be taken in the fiscal area. The deficit is high--about 12 percent--and expenditures remain large, particularly as a result of security-related expenditures. The public enterprise reform program should be helpful in this respect. In addition, we commend the authorities' intent to control nondefense expenditures to help compensate for the high defense expenditures; however, we must caution against focusing too much expenditure control on the investment program. Expenditures have to be controlled in some areas, but Sri Lanka needs a core investment program in order to continue development. To make the best use of those funds allocated to the investment program, we urge the authorities actively to involve the Bank in assessing the investment program. I understand that a policy framework paper and a request for a drawing under the structural adjustment facility may be brought forward; if so, I certainly would like the World Bank to make a full assessment of public expenditures and the investment program.

The authorities have taken some steps toward changing the tax system. Mr. Fernando notes the reductions in the maximum marginal rate of corporate and personal income taxes, as well as the reduction in the number of rate bands under the income tax structure and the turnover tax. These steps seem to be in the right direction, and, as we suggested a year ago, a more comprehensive tax reform effort might be worth consideration. I understand that further reform is planned, including an additional simplification of the tax structure and a shifting of some of the burden from international to domestic taxation. It would be helpful to have further information from the staff on the details of the tax reform and on the timing of further action in this area. It would also be appropriate to cover the specifics of the tax reform and additional public enterprise reform measures in the upcoming policy framework paper and the request for funding under the structural adjustment facility.

A diversification of exports, more specifically a boosting of nontraditional exports, is needed to help address external imbalances. The use of fiscal incentives to strengthen external performance could prove to be complicated and could also make more difficult the desired reform and simplification of the tax structure. I would stress that the authorities' market-related orientation would be quite helpful in promoting exports and further trade liberalization. Market-related incentives, including a flexible exchange rate policy, would be most useful to shore up the external accounts.

All in all, we believe that the authorities are on the right track. We urge them to persevere with the needed policy adjustments, and we urge that measues be implemented as soon as possible in the reforms of the public enterprises, public sector staffing, and taxation.

Mrs. Filardo made the following statement:

Sri Lanka has been adversely affected by external developments such as the deterioration of the terms of trade and the reduction of its volume of trade, but also internally--by the ethnic conflict and bad weather conditions that have had an unfavorable impact on the country and on the implementation of policy adjustment. As Mr. Fernando has stressed, the fiscal and external imbalances have thus been seriously exacerbated, and it is against this background that the economic situation has to be assessed.

A particular problem facing Sri Lanka is the shortcomings related to the availability and processing of the economic and financial data, which make it difficult to obtain the reliable information that is fundamental for fiscal policy formulation and monitoring. In this regard, it is most welcome that the Fund has been helping the authorities to organize the collection of data. The other point of serious concern is the problem of security, which is absorbing budgetary revenues in considerable amounts. The fiscal situation of Sri Lanka is very fragile. Therefore, we agree with the staff that it is imperative that the burden of subsidies and transfers be reduced and that efficiency in the civil service and the public corporations be improved. The medium-term approach that the authorities are developing to correct this delicate situation is welcome.

The balance of payments remains highly vulnerable; moreover, the ethnic conflict, the uncertain weather conditions, and the protectionist barriers in foreign markets pose serious difficulties in the implementation of trade reforms and exchange policy. Accordingly, it is encouraging to observe the commitment of the authorities to devise a sound strategy to improve this situation. The announcement by Mr. Fernando that a peace treaty is about to be signed is also most welcome. We hope that these developments will re-establish confidence in the country and that the authorities will be able to maintain their commitments. In concluding, we support the proposed decision.

Mr. Yamazaki made the following statement:

First, I wish to concur with the previous speakers who expressed the wish for an early restoration of stability in Sri Lanka. As a result of the internal civil conflict and the external adverse economic environment, the economy stagnated in 1986, and the fiscal and external imbalances remained substantial. In the meantime, the deep-rooted structural weakness of the economy has emerged more clearly. Specifically, the economy is characterized by a large public sector--especially the public enterprises that are supported by government subsidies and transfers--and by a vulnerable export structure that relies mainly upon a few commodities. The stubborn structural weaknesses in the economy will require a strong response, especially in view of the medium-term outlook. Although the authorities' medium-term scenario gives us a brighter view, some of the assessments are still questioned by the staff. According to the staff paper, moreover, a financial gap of some SDR 500 million is likely to emerge in 1988-91, and this could be even larger if the external economic situation becomes worse.

I of course have deep sympathy with the authorities in the face of their difficult situation. Indeed, some of the adverse factors have been beyond the authorities' control, and I would like to commend them for their efforts made thus far despite such a difficult situation. Nonetheless, I believe that this severe situation well justifies the need for the authorities to introduce stronger adjustment and structural policies.

Future developments in fiscal policy depend upon the size of defense-related expenditure, and therefore much uncertainty still remains. Nonetheless, the current fiscal deficit--as much as 10 percent of GDP--seems to be clearly unsustainable, and further retrenchment is called for. Current revenues are insufficient to reduce the fiscal deficit to a sustainable level, and tax revenue should be raised, particularly through broadening the tax base. As the authorities' scope for raising revenues is limited in the short term, more attention should also be focused upon expenditure cuts. As for the modality of the retrenchment, measures that rely heavily on the compression of the capital expenditure program through across-the-board cuts would be, as the authorities are rightly aware, unsustainable and less productive. Instead, I urge that the budgetary burden of subsidies and transfers be reduced and that a cautious wage policy be employed. From this point of view I support the authorities' objectives of further rationalizing the public enterprises and I hope that great emphasis will be placed on this rationalization as a benchmark in the program, for which a request for funding under the structural adjustment facility is forthcoming.

On monetary policy, I will say briefly that caution is required in the face of the recent pickup in the rate of inflation.

The slow growth of outstanding external indebtedness and the improvement in the structure of debt in 1986 reflects the authorities' judicious external debt management. The shares of commercial and short-term debt in Sri Lanka's total indebtedness have been reduced to 25 percent and 6 percent, respectively, an achievement for which the authorities should be highly commended. The flexible exchange rate policy will be an effective tool for export diversification. Despite the recent real effective depreciation of the Sri Lanka rupee, it has not depreciated sufficiently against the currencies of the major competitor countries, and the authorities should exercise a more active exchange rate policy.

The problems of Sri Lanka's economy are largely structural in nature, and the corrective measures should be set for the medium term. I hope that a sufficient adjustment program will be designed in the context of the structural adjustment facility and I look forward to discussing it in the future. Finally, I support the proposed decision.

Mr. Zaidi made the following statement:

In recent years, the Sri Lanka authorities have implemented a number of measures to achieve sustained growth and a viable balance of payments. The economic strategy has focused on reducing the inflation rate, improving the external performance, intensifying structural reforms, and increasing the market orientation of the economy. The task of transforming the economy into a more competitive and open one is not easy, and the difficulties the authorities faced were accentuated by the increasing damage arising from the ethnic conflict and by the adverse external conditions such as the sharp decline in the terms of trade. As Mr. Fernando has noted, these adverse conditions had an unfavorable impact on adjustment policies, contributed to a worsening of the fiscal imbalance, and renewed the strains on the balance of payments. Economic growth has slowed, and there has been greater pressure on domestic prices. To overcome these problems, a determined effort over a number of years is required, and the success of the economic strategy will depend crucially on the authorities' ability to inspire sufficient credibility and confidence by maintaining the momentum of the adjustment policies.

One of the most critical elements in the attainment of a viable overall economic performance is fiscal policy. Despite some progress, the budget deficit remains relatively large. In this regard, it is encouraging that a vital element of the structural adjustment program is the reduction of the fiscal deficit. Also welcome is the authorities' plan to reduce the deficit over the medium term to a level that can be financed primarily by concessional foreign financing, thus limiting the need for domestic borrowing and nonconcessional financing.

As in many other low-income developing countries, the external imbalance in Sri Lanka is basically structural in nature. The staff has noted that exports remain overly dependent on primary commodities and vulnerable to fluctuations in international commodity prices. In order to increase exports in a steady and sustained manner, it has been necessary to expand and diversify the narrow export base. The authorities have taken steps in this direction, including the flexible exchange rate policy that has resulted in a real effective depreciation in 1985 and 1986. Furthermore, the exchange control, banking, and duty rebate procedures have been simplified so as to reduce the administrative cost to exporters. This should contribute to an improvement in export performance.

Looking ahead to the medium-term prospects, one notes that although the debt service ratio is expected to decline from 26 percent of current account receipts in 1987 to 19 percent in 1991, there will be a financing gap, after identified capital inflows, of about SDR 500 million in 1988-91. The staff has clearly outlined its assumptions for the medium-term projections, and has pointed to a number of factors that could result in a less optimistic assessment of the medium-term outlook. In particular, if nontraditional exports grew by 1 percentage point less each year, the current account deficit and the cumulative financing gap would be significantly higher. The limited latitude for financing demand imbalances externally, together with the fact that the medium-term projections are predicated on a number of key environmental and policy assumptions, underscores the need for the authorities to persevere with their commendable adjustment efforts and safeguard the medium-term prospects of the economy.

Mr. Posthumus recalled that Mr. Fernando had indicated that if defense-related expenditures were excluded from the calculations, government expenditure had declined from 29 percent of GDP in 1986 to 26 percent of GDP in 1987--a substantial decline--which showed that expenditures other than defense-related expenditures were being suppressed.

While it was true that an increase in the private sector share of expenditure meant a decrease in the public sector share, that did not necessarily mean that a decrease in the size of the public sector had occurred, Mr. Posthumus commented. In addition, there might be expenditures in the public sector that would not have high priority and could be carried out better by the private sector. However, there might also be current and capital expenditures in the public sector that had been suppressed for a long time--for example, government salaries.

Sri Lanka's public sector share of expenditure over the years--between 30 percent and 35 percent of GDP--did not seem unduly large, Mr. Posthumus went on. Of course, more information was necessary before a definitive judgment could be made. His point, however, was that in many countries, including developing countries, government expenditure had to play a vital role--in investment, for example--and thus one had to remember that there were indeed positive aspects of such expenditure. Of course, that also meant that attention needed to be given to tax reforms that would result in a better tax system.

The staff representative from the Asian Department said that the staff had discussed a number of tax reform measures during the consultation with the authorities. The authorities intended to implement as many measures as feasible in the budget for 1988, which was to be presented in November 1987; they intended to announce the reform and to phase the measures over a three-year period, although the exact details of the phasing had not yet been specified.

The authorities were trying to balance a number of competing factors as they considered the tax reform, the staff representative continued. With respect to income tax, the authorities had discussed with the staff the scope for reducing or abolishing a wide range of deductions, exceptions, and tax holidays, which applied not just to the export sector of the economy but also to the import substitution sector, construction, and housing, as well as to civil service salaries and some interest income from national institutions such as the National Savings Bank.

The authorities feared a short-term revenue loss from some of the proposed tax reform measures, such as the proposed reduction in the highest marginal tax rate, and they were concerned about the extent to which revenues would actually increase as a result of the abolition of tax holidays, the staff representative went on. Accordingly, they were exploring the feasibility of compensating for revenue losses by means such as the business turnover tax. The authorities had expressed the fear that they might discourage intermediation through the banking system if they imposed taxes on certain instruments that were currently tax exempt. They had also indicated that civil service salaries might have to be raised again before being subjected to income taxation.

The staff had made specific recommendations for changes in the tax structure, the staff representative from the Asian Department added. Those changes were aimed principally at broadening the base of domestic taxes such as the business turnover tax and, in the case of excise taxes, shifting insofar as possible from specific to ad valorem, to increase elasticity. As noted in the staff report, other actions were being contemplated to simplify and reduce the level of import tariffs. The authorities were considering another round of comprehensive tariff reform in which all export taxes would be abolished except those on the major plantation crops, so that no tax would remain on the minor export commodities.

Mr. Fernando commented that while the public enterprises had contributed to the fiscal imbalance in Sri Lanka, it was useful to note that among those enterprises, the manufacturing sector had not been responsible for the drain on the budget. In fact, the budgetary transfers--both current and capital--to that sector had dropped from 6 percent of GDP in 1980 to 0.5 percent in 1985. Moreover, the most recent output data indicated that many industrial corporations had increased their real output by 8 percent in 1986, compared with a decline in the previous year.

The transfers to the national airline in 1986 had been approximately 0.7 percent of GDP, Mr. Fernando recalled. The question of closing the airline had not been overlooked, although in view of the substantial borrowing that had been undertaken, it did not seem feasible to close the airline completely. In either case, the debt servicing would continue to be a drain on the budget. The ethnic conflict had adversely affected tourist arrivals on the national airline as well as the airline operations. Given those developments, the airline had been restructured, with a measure of rationalization of the network and a reduction in staff, as a means of reducing the drain on the budget.

The ethnic conflict had also affected the operations of the important Sri Lanka Cement Corporation, Mr. Fernando went on. The Corporation's difficulties had been compounded because it had borrowed abroad, and with the depreciation of Sri Lanka's currency, the debt burden had increased considerably. However, once peace was restored, the prospects for the Cement Corporation would improve significantly.

A final point to remember with respect to the public enterprises was the great difficulty that the authorities faced in trying to close some of the nonviable public enterprises, Mr. Fernando stated. For example, a manufacturing corporation had been initiated, with support from a multilateral institution, and although it soon had been apparent that the enterprise could not become viable, it had been extremely difficult for the authorities to close it. Despite many proposals for revamping the corporation, it had finally been closed; however, the liabilities of that corporation still constituted a drain on the government budget. Those difficulties were a reality that could not be ignored when one discussed the narrow budgetary aspects of closing nonviable public enterprises as well as the overall issue of reducing the role of the Government in economic activity.

The authorities had contacted the World Bank and the International Finance Corporation with a view toward obtaining expert technical assistance for the development of the capital market in Sri Lanka, Mr. Fernando noted. In addition, the Parliament had passed the Securities Council Bill that would set up the stock exchange and regulate trading.

It was true that there were uncertainties associated with the projections for Sri Lanka's balance of payments position, given the vulnerability of the economy to external factors, Mr. Fernando said. However, it seemed that one of the risks mentioned in the analysis--the escalation of military expenditure--would not occur. There should be an immediate improvement in the balance of payments with the cessation of the ethnic conflict, inasmuch as defense expenditures would fall both in real and nominal terms.

He had not excluded defense-related expenditures in the calculations cited in his opening remarks, Mr. Fernando explained. Instead, he had tried to illustrate the amount of defense expenditures that were related to the ethnic conflict, as opposed to what might be called a normal level of such expenditures. That adjustment for expenditures related to the ethnic conflict had thus highlighted the declining trend of government expenditure as a share of GDP.

As for any apparent reduction of the Government's share of current and capital expenditures, it was important to examine the figures carefully, Mr. Fernando remarked. The budget showed that the Government was continuing to provide for transfers to the public enterprises. The authorities intended to improve the efficiency of the public enterprises, but any reduction in capital transfers would not necessarily mean a reduction in the impact of expenditures on investment. Moreover, a reduction of government expenditures did not necessarily imply a harmful effect on growth, because that reduction was being implemented along with the privatization measures, and those efforts were expected to improve confidence and encourage more private sector investment.

The Acting Chairman made the following summing up:

> Directors expressed concern about key aspects of Sri Lanka's economic performance during the past year. The large and unsustainable internal and external imbalances had persisted, putting pressure on prices, and growth had slowed. Directors recognized that economic management had been made more difficult by many adverse external and domestic factors, and they expressed the hope that the restoration of internal security would restore general confidence. However, they also pointed to a number of policy weaknesses and long-standing structural problems in the economy. In that context, Directors welcomed the authorities' intentions to strengthen policies and develop a comprehensive adjustment program so as to reduce fiscal imbalances and address structural weaknesses in the economy. Directors expressed the hope that such a program could become the basis for Fund support under the structural adjustment facility.

Directors viewed improved public policies as the key to financial stability and enduring structural adjustment in Sri Lanka. They welcomed the recent announcement of a medium-term fiscal strategy and stressed the importance of adherence to the 1987 budget deficit target and action across a broad spectrum of difficult policy areas.

While there was some scope to reduce public investment, the compression of such outlays was not a sustainable adjustment strategy, as it would be detrimental to economic growth. Therefore, Directors especially emphasized the need for cuts in budget subsidies and transfers, improved accounting and control procedures, and greater restraint in public sector wages. They also called for priority attention to long-standing problems of inefficiency and overstaffing in the public sector. At the same time, some Directors pointed to the need for the public sector to pay competitive salaries in order to maintain a high-quality staff.

Directors reiterated the need for measures to improve the economic performance of the public enterprises. They urged the authorities to act decisively in formulating and implementing a reform that would reduce budgetary burdens and enhance the overall efficiency of the economy. An essential element of that reform would be the effective monitoring of the enterprises and extra-budgetary units. Directors also urged the authorities to press ahead with the closure of nonviable enterprises, the dismantling of public sector monopolies, and the further privatization of public enterprises.

While Directors were in agreement with the primary role assigned to public expenditure restraint over the medium term in achieving envisaged fiscal adjustment, they also pointed to the need for tax reform to increase the efficiency of the tax system, raise its elasticity, and broaden the domestic tax base.

Directors agreed that the present circumstances called for caution in the exercise of monetary policy in order to avoid an acceleration of inflation. Directors welcomed the greater role accorded to market forces in the determination of interest rates and the reduced reliance on direct credit controls. They supported the further development of the treasury bill auction, which could increase the scope for open-market operations in the conduct of monetary policy.

There was a clear consensus on the need for a substantial strengthening of the balance of payments over the medium term. Directors particularly commented on Sri Lanka's continued dependence on a weak export base, the unsustainability of the present level of current account deficits, and the prospect of lower levels of concessional assistance. Directors welcomed the authorities' intention to use exchange rate policy more actively to strengthen the balance of payments, but they cautioned against the use of fiscal incentives. An active exchange rate policy was deemed essential in view of the projected financing gaps in the balance of payments and the need to strengthen nontraditional export growth and further diversification in the medium term. Directors also cautioned that there was a need to keep domestic wages and prices under control to preserve the gains from planned flexibility in the exchange rate.

Directors expressed broad agreement with the thrust of the structural policies that formed the basis of the authorities' medium-term adjustment program and the balance of payments outlook. They urged early adoption of the specific measures that would support the authorities' strategy, ensure an orderly reduction of the external deficit to a sustainable level, and protect growth prospects. Directors recognized that effective implementation of further tariff reform and trade liberalization, as well as public enterprise reform, would not be easy in the current environment, but, in their view, the necessary return of private confidence and future growth depended importantly on substantive progress in those areas.

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 Fund takes this decision in concluding the 1987 Article XIV consultation with Sri Lanka, in the light of the 1987 Article IV consultation with Sri Lanka conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Sri Lanka continues to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions, except for the restriction arising from the limitations on the availability of foreign exchange for personal travel abroad, which is maintained in accordance with the transitional arrangements of Article XIV, Section 2.

Decision No. 8668-(87/115), adopted
August 3, 1987

3. PAKISTAN - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Pakistan (SM/87/137, 6/22/87; Sup. 1, 7/22/87). They also had before them a background paper on recent economic developments in Pakistan (SM/87/152, 7/9/87).

The staff representative from the Middle Eastern Department noted that the estimate of recourse to the domestic banking system to finance the fiscal deficit in 1986/87 mentioned on page 3 of Supplement 1 to the staff report should read PRs 11.5 billion, rather than PRs 11.7 billion.

Mr. Finaish made the following statement:

Pakistan has pursued a wide range of adjustment policies in the 1980s, responsive to changing internal and external circumstances. Although unfavorable external conditions--recession in important export markets, significant decline in workers' remittances, and growing protectionism--have hampered Pakistan's efforts to adjust, considerable progress has been made in restraining domestic demand and containing inflationary pressures. The progress achieved thus far in the adjustment of the economy finds strong expression in the high rate of real output growth and the reduced rate of inflation. From 1981/82 to 1985/86, real GDP rose at an average annual rate of 7 percent, and this growth momentum was maintained in 1986/87. The rate of inflation has declined progressively since 1983/84, and consumer prices rose by only about 4 percent in the 12 months to May 1987. In recent years, the authorities have pursued a flexible exchange rate policy, which has entailed a substantial real depreciation of the rupee. Greater flexibility is now permitted for borrowing and deposit rates, and the authorities have followed a traditionally cautious external borrowing policy. However, there are pressures on both the budget and the balance of payments positions, and the domestic savings and investment rates have been relatively low over the past years.

As in many other low-income developing countries, the economic problems in Pakistan are not primarily cyclical in origin, and they may be attributed to a number of other causes that can best be described as structural. One of these is the limited diversification of exports, in terms both of commodities and of countries of destination, which makes it difficult to achieve a rate of export growth that can sustain increasing imports and income. The balance of payments outcome remains heavily dependent on a narrow range of commodities whose demand and price prospects are uncertain, and on the remittances of workers whose employment opportunities in the oil exporting countries in the region have diminished. The authorities recognize that if the narrow export base is to be expanded and diversified, a major and multiyear effort is needed to restructure the industrial base and change the system of trade incentives. The authorities are also mindful of the need to rectify certain other structural imbalances, and are formulating a wide range of medium-term policies of a structural nature, including increased domestic resource mobilization to finance higher investment spending, increased selectivity in public investment to improve the physical and social infrastructure, and further deregulation to encourage growth in private investment and improve efficiency.

It should also be noted that important steps have already been taken to promote the objective of structural adjustment. Helped by favorable weather conditions, the measures implemented under the Government's National Agricultural Policy to enhance productivity have contributed to the vigorous growth in agriculture. Programs have been established to enhance the availability and quality of inputs, such as fertilizers, seeds, and pesticides. The authorities have further decreased government control over agricultural prices and operations in 1986-87, including the elimination of the government monopoly of edible oils imports, opening the domestic Basmati rice trade to the private sector, and decontrol of domestic wheat prices and trade. Furthermore, domestic production of crude oil increased threefold during 1984/85-1985/86 following the implementation of the accelerated program of exploration and a policy of increasing producer prices. As a result, domestic oil production covered 26 percent of consumption by 1985/86, compared with 10 percent in 1981/82. Several policy measures to encourage private sector industrial activity have also been implemented in line with the Government's policy of delegating responsibility in investment in manufacturing to the private sector and shifting public sector investment to other sectors.

In the areas of government expenditures and taxation, the measures adopted are designed to contain this year's budget deficit to a much lower level than would have resulted from unchanged policies. The deep awareness of the authorities of the difficult budgetary condition is reflected in the austerity drive that is being implemented in the present fiscal year. In the revised budget proposals for 1987/88 that have been approved by the National Assembly, the overall fiscal deficit/GDP ratio will be contained to 7.6 percent, compared with 8.8 percent in 1986/87. The budget incorporated a strong tax effort, cuts in current and capital expenditures, and measures to improve the financial position of public enterprises. The revenue measures include the extension of the sales tax to cigarettes and beverages, an export tax on cotton yarn, a foreign travel tax, and an increase in the import license fee. The tax collection machinery has been strengthened in an effort to increase revenues, particularly from income and profit taxes and federal excises. On the expenditure side, the authorities intend to contain the rate of growth of expenditure to 10.7 percent, which is less than the estimated growth of nominal GDP to 11.9 percent. The growth rate of current expenditure will be reduced from 16.8 percent in 1986/87 to 12.2 percent in 1987/88, and for development expenditure from 13.4 percent to 9.7 percent.

Although the fiscal deficit remains large, the fiscal performance should be measured against the backdrop of the unforeseen adverse developments, both in Pakistan and in the region as a whole. The fiscal performance is much better than would at first appear under the circumstances, because the authorities avoided the further deterioration that could have been expected from the adverse developments. In great part, the problems related to the fiscal area are of a structural nature, and rapid changes cannot realistically be expected. Budgetary receipts are to a large extent dependent on foreign trade, and the scope for reductions in current expenditure is limited by rising interest payments and defense outlays. A shift toward increased revenues from domestic activities rather than from foreign trade is necessary, but it takes time to accomplish. Moreover, the presence in the country of a large number of refugees has placed an enormous burden on Pakistan's physical and financial resources. The Afghan refugees in Pakistan are the largest single concentration of refugees in the world today, and at over three million refugees, they constitute a very large proportion of the total refugee population of the world.

Efforts to improve the performance of public corporations so as to reduce their dependence on budgetary transfers remain an important element of the Government's strategy to strengthen its financial position. The authorities have implemented since 1982 an incentive scheme to reward managers on the basis of actual performance. The incentive scheme was supplemented in June 1986 by a corporate planning system, which involves assisting individual public corporations in the preparation of development plans and budgets. In addition to the comprehensive program aimed at addressing the longer-term goal of improved efficiency in those corporations that are to be retained in the public sector, procedural decisions were reached regarding the method of divestiture; 12 industrial units controlled by the Ministry of Production were identified for sale to the private sector in January 1986. All 12 units were advertised for sale and two units were divested. The authorities are determined to have the public enterprises operate in the future on a more commercially sound basis and to reduce drawings on the Central Government.

As in the past, monetary policy has been directed toward ensuring a pace of monetary expansion that is consistent with reasonable price stability. Monetary policy is conducted with reference to a broad range of financial and economic indicators, and the growth in domestic liquidity has been broadly in line with that of nominal GDP. Direct and selective controls have been the primary instrument for regulating the growth and distribution of domestic credit, and the credit guidelines have been adequate to cater to the demands of the private sector. In 1986/87, because the overall fiscal deficit was larger than forecast and in the light of the significant increase in agricultural output, credit expansion came under pressure and additional recourse to nonbank domestic borrowing was necessary. The authorities have taken measures to contain the overall fiscal deficit, and thus the recourse to both bank and nonbank financing. However, nonbank financing has had the effect of facilitating better control over the monetary aggregates and reducing reliance on foreign borrowing. The stance of monetary policy during 1987/88 will continue to be one of restraint and growth of broad money will be held to 12 percent.

The importance attached by the authorities to the financial sector in the overall structural adjustment process is reflected in the implementation of several measures aimed at improving the efficiency of credit allocation, introducing more competition into the financial sector, and reducing the cost of financial intermediation. In 1985, all financial operations of the scheduled banks were placed on an Islamic noninterest basis. As the staff has noted, this conversion has effectively resulted in financial deregulation and in the introduction of greater flexibility in the structure of rates for financing and deposits than existed previously. Banks have been free to act individually on their deposit rates in the system of profit- and loss-sharing deposit accounts, and deposit rates may vary according to individual banks' profitability and types of deposits. In 1985/86, the weighted average annual rates of return paid on the profit- and loss-sharing term deposits ranged from 8.7 percent for deposits under six months to 13.5 percent for five-year deposits, while the inflation rate was 5 percent.

The authorities fully recognize the structural weakness of the balance of payments and the fact that continued growth with balance of payments viability over the medium term cannot be achieved without securing higher growth of nontraditional exports and reducing reliance on workers' remittances as a source of foreign exchange. Diversification and expansion of the export sector therefore remain a prime objective. To strengthen the balance of payments, the authorities have followed a flexible exchange rate policy and essentially have let the rupee move down with the decline of the U.S. dollar against other major currencies. From July 1986 to April 1987, the rupee depreciated further by 13 percent in real effective terms against the currencies of major industrial countries. The authorities have pursued a liberal policy in respect of imports of industrial raw materials and spare parts, with the view that easier availability of inputs should facilitate strengthening the productive base of nontraditional exports. The new trade policy for 1987/88-1989/90 includes an intention of granting graduated income tax relief on the basis of the value added in each category of exports. In addition to the existing policy that permits drawback of import duty and sales tax, full drawback will be allowed for the import content of exports in respect of the import surcharge. The new policy also involves removing 136 items from the negative list, permitting duty-free import of cotton yarn, and raising the monetary ceilings on the imports of machinery. The authorities remain very concerned about the continued pressures that exist in many countries to resort to protectionist trade measures, and the damaging effect that protectionism is having on the access to markets.

As to the medium-term outlook, the staff has provided three sets of balance of payments and debt service projections in Appendix III of the staff report. The first one is based on the authorities' assumptions, whereas the other two are staff scenarios. One of the staf scenarios is based on maintenence of current policies and the other assumes the adoption of policy adjustment measures. It is important to emphasize that the staff scenario based on maintenance of current policies is in no sense a forecast. The scenario can be considered a realistic projection only to the extent that the assumptions are considered plausible for the major variables in the economy. But government policy is not set out for six years ahead, without regard for the feedback provided by information on the actual outcome of policies as well as other exogenous developments in the intervening years. This applies in particular to the external sector policies in a country where the protracted nature of the balance of payments problems constitutes a major consideration in policy formulation. In this regard, it should be noted that the current account deficit/GNP ratio has been reduced from 5 percent in 1984/85 to 3.5 percent in 1985/86, and further to 2.0 percent in 1986/87. The authorities believe that an export-led economic strategy, together with prudent demand management and structural reforms, can result in a medium-term economic performance even better than that projected by the staff for the scenario with policy adjustment measures. The authorities are determined to continue their cautious external debt policy so as to limit short-term commercial borrowing, which is viewed as a transitional measure, and to maintain the debt-servicing burden within manageable levels.

In conclusion, the authorities have achieved considerable progress in output growth, inflation, financial sector reform, and exchange rate management. They recognize the need to improve the fiscal position, and to expand and diversify the narrow export base. They plan to continue the laborious process of restructuring the economy, improving the instruments of demand management, and enhancing efficiency through greater reliance on market forces with reduced government intervention in the economy. Their past adjustment record should give confidence in their ability to pursue such a strategy in a pragmatic way within the existing economic and political limits.

Mr. Dai made the following statement:

High economic growth and a moderate inflation rate have been the remarkable features of the Pakistani economy in recent years. The record levels of the cotton and wheat harvests, the strong expansion in the oil industry, and gains in chemical and cement production have all contributed to the country's relatively strong economic growth. Underlying these impressive achievements are the significant structural reforms and price incentives implemented in the early 1980s. More important, the authorities are not content with what they have achieved, and are taking further steps to deregulate certain economic activities and enhance exchange rate management in order to sustain the present economic expansion. In sum, the overall situation of the economy is encouraging, and the authorities' persistent efforts to invigorate the economy are commendable.

The fiscal area gives rise to major concern. As the latest data indicate, current expenditure increased significantly faster than had been anticipated. With the possibility of a further rise in the budget deficit, the Government will be forced to resort to further domestic and external borrowing, adding to the already high domestic and external debt. Such a development will certainly have an adverse impact on Pakistan's external position, as well as on domestic price performance. I note that the authorities are well aware of the need for a major reform in the structure of the public finances. The National Taxation Reform Commission has put forward its recommendations for major tax changes, including the introduction of an across-the-board single-rate sales tax, presumptive taxes for small and medium enterprises, reduced customs duty rates, and the removal of sales tax exemptions. I do hope that these measures will be implemented promptly in order to alleviate difficulties in the area of public finances.

With regard to balance of payments prospects, exports of the cotton-based manufactures will probably continue to expand. Nevertheless, worker-remittance inflows are expected to decline, and exports of nontraditional manufactures may face difficulties, particularly because of trade barriers in the industrial countries. In addition, given the uncertain weather conditions that always have a significant impact on the cotton crops, the authorities need to diversify further the export base and enhance the competitiveness of Pakistani products. Moreover, efforts should be made to keep the external debt within manageable levels.

Despite the rapid growth of the economy, gross domestic savings and gross domestic fixed investment in Pakistan remain low. Staff comment on this trend would be helpful. Finally, I support the proposed decision.

Mr. Nimatallah made the following statement:

Pakistan's strong growth with low inflation has certainly been impressive. I am particularly encouraged by the strong growth in wheat and cotton production and the associated buoyancy in the manufacturing sector. The authorities have also been successful in maintaining a high growth rate for traditional exports, which has permitted a helpful improvement in the external accounts, despite a continued fall in worker-remittance inflows.

Despite this commendable performance, much remains to be done. This is particularly true, as recognized by Mr. Finaish in his opening statement, in the interrelated areas of savings, fiscal performance, liberalization of the economy, enhanced participation of the private sector, and diversification of exports.

I believe that the progress made in the areas of mobilization of resources can be improved. Furthermore, the present investment/savings rate remains low. At 16 percent, the country's gross domestic investment rate does not compare well with, for example, an average gross domestic investment rate for low-income countries of about 20-25 percent. More worrying is the low level of domestic savings. Domestic savings rates, while clearly on an increasing trend, remain modest and imply more dependence on foreign savings than can be sustained, in the light of Pakistan's external debt situation and the needed investment rate. Thus, the goal of a substantial improvement in the savings rate should be accorded high priority. The question is how to raise this rate.

As the authorities recognize, fiscal policy has an important role to play in improving domestic savings, in addition to maintaining low inflation and easing pressure on the balance of payments. The authorities have been making progress on the fiscal front, and they are attempting to reduce the fiscal imbalance within the context of the 1987/88 budget. However, in the light of the recommendations of the National Tax Reform Commission, the fiscal position may have to be strengthened further over the coming years, with a view to enhancing the savings rate over time.

The authorities should improve the quality of expenditures as the necessary tightening of public spending takes place. The rising fiscal deficit in recent years, combined with some decline in external financing, has led to increased reliance on domestic bank and nonbank financing. This trend could become a cause for concern as growth rates for money and credits accelerate. In addition to bidding up interest rates and discouraging private investment, the trend goes counter to one of the objectives of shifting the mix of investments in favor of the private sector. In sum, it is important to control public expenditure and improve its quality by making the public sector more efficient over time.

As remittances have failed to recover to previous levels, it will be necessary for the authorities to accelerate their efforts to develop new sources of foreign exchange through diversification of exports. That necessity means more appropriate domestic policies and better access to foreign markets. In addition, more deregulation and the removal of impediments to foreign direct investments will be helpful. In conclusion, I commend the authorities for their determination to persist with their growth-oriented adjustment policies.

Mrs. Filardo made the following statement:

The assessment of Pakistan's economic performance should be made in the context of its status as one of the poorest countries in the world. With 100 million people, a population growth rate of 3 percent, and a per capita GDP of $357, the main challenge ahead for the authorities should be to pursue development and sustainable economic growth. Along with the authorities' implementation of sound macroeconomic policies and structural reforms, multilateral institutions and bilateral donors must give Pakistan financial support on concessional terms. In this regard, since 1981 the performance of the country's economy has been remarkable; not only has real GDP grown by more than 6 percent annually, but the inflation rate has also remained relatively low, and progress has been achieved in the areas of education, health, and infant mortality. Nevertheless, the problems of the country are far from being solved, and the authorities are still facing a very delicate situation that could hinder the achievements of the past few years, namely, the vulnerability of the external sector, the exchange and trade policies, the fiscal deficit, and the expansion in domestic credit.

Even though the trade balance has been structurally weak because of the large disequilibria between exports and imports, this has been counterbalanced largely by external financial aid, and it is likely to continue to be so. Nevertheless, the external sector is particularly vulnerable because rice and cotton account for more than one half of the country's exports, nontraditional exports have stagnated, the country relies heavily on remittance transfers from its workers abroad, and foreign liabilities have accumulated in the form of deposits by nonresident commercial banks and nonbank entities. Accordingly, the authorities should give careful attention to the management of this precarious, delicate situation, and they should implement a substantial adjustment and structural effort. This comprehensive effort should cover a more liberal trade policy, gradually eliminating protectionism, shifting from quantitative controls to tariffs, and applying a more flexible exchange rate to enhance the competitiveness of Pakistani goods. I agree with Mr. Finaish that a major, multiyear effort is needed to restructure the industrial base and change the system of trade incentives. By the same token, imports should be restrained through the implementation of more restrictive fiscal and monetary policies.

An element of fundamental concern remains in relation to the way in which the country has been accumulating international reserves. In this regard, the authorities should manage the external debt very cautiously and should avoid relying on short-term commitments.

In relation to the fiscal position, it has been noted that the overall deficits have increased steadily since 1980. This deterioration is the result of shortfalls in revenues and sustained increases in current expenditures, mainly stemming from higher interest rates, and defense outlays and rising subsidies. To finance the expanded deficit, substantial resources had to be obtained from the nonbanking system. In this respect, it has been disappointing to learn that the preliminary fiscal data for 1986/87 indicate that current expenditure increased significantly, as well as development expenditure. Therefore, the fiscal deficit might even rise above the original projection of 7.5 percent of GDP, to 8.8 percent of GDP. Furthermore, in the budget proposal for 1987/88, the authorities had planned to meet the fiscal deficit target by raising additional tax revenue, but they finally had to withdraw that plan as a result of social and political opposition. Nevertheless, in the revised budget proposal the fiscal deficit goal is substantially lower, mainly because of other tax measures and certain expenditure cuts. The staff has raised serious doubts about the possibility of accomplishing such goals. Additional staff comment on this point would be useful, since Mr. Finaish has stressed this issue in his opening statement, and has explained that the budget has rigidities on the expenditure side that will take time to eliminate. In any case, given the fragile situation of the public finances, the Government must enhance revenue by introducing structural reforms, modifying the tax structure, and progressively eliminating explicit and implicit subsidies.

The staff observes in the background paper that domestic credit has remained high since 1981, with significant changes from one year to the next. The major factors contributing to this outcome have been the Government's difficulties in executing fiscal policies. While the economy has been growing at a sustainable rate with a relatively low rate of inflation, it is important to maintain discipline and avoid the financing of the deficit through money creation; which could increase inflationary pressures and affect the external sector because of an increase in imports. It is of special concern that several constraints have emerged that could renew pressure on domestic credit expansion, namely, the delays in the elaboration of fiscal reforms and in the receipt of aid resources from nonproject loans. It would be helpful to have additional comment from the staff or Mr. Finaish in this regard.

On the medium-term outlook, I have observed discrepancies between the position of staff and that of Mr. Finaish; I agree with him that the assumptions made by the staff could only be plausible for the major variables, taking into account the possible exogenous developments in the intervening years, and given the protracted nature of the balance of payments problems. Staff comments on the feasibility of its medium-term scenarios would be useful. Finally, I support the proposed decision.

Mr. Binay made the following statement:

I welcome the authorities' success over recent years in achieving strong economic growth with a modest rate of inflation, and thereby accommodating the basic needs of the country's increasing population. Major factors contributing to this strong growth include buoyant workers' remittances, enhanced price incentives for exportable agricultural products, and the promotion of oil and gas production. The present year is expected to witness the continued divestiture of unprofitable public enterprises, further successful exchange rate adjustments, an improvement in the current account deficit, the realization of the Government's intention of pursuing current barter agreements on a cash basis, and an increase in the domestic savings ratio stemming from positive real rates of return on various financial instruments. These are all encouraging developments. Today I would like to focus on some warning signals in the area of fiscal policy, and I will also touch upon budgetary revenues and the supply policies of Pakistan.

I still feel some concern over the authorities' implementation of the major structural reforms, especially in the fiscal policy area. In 1986/87, the ratio of interest payments on domestic debt to total revenue was 16.3 percent, which is far from sustainable. Any slippage in the policy of maintaining positive real rates of return would quickly be translated into a surge in domestic demand, a deterioration of the current account, imported goods shortages owing to the structural characteristics of Pakistan's reserves, and enormous inflationary pressures.

In addition, I wonder about the new discretionary measures for enhancing revenues embodied in the 1987/88 budget. First, the proposed discriminatory pricing of petroleum products and natural gas will be difficult to administer and will add to the already prevalent price distortions. The fostering of certain industries could be more easily achieved by other means, such as tax incentives or increased tariffs. Second, the newly levied tax on cotton yarn resembles an excise tax that will bear directly on cotton farmers, rather than on the exporters as intended. Because Pakistan is a price taker rather than a price maker in the world cotton yarn market, the exporters of cotton yarns will be forced to deduct the amount of the tax from the price they pay to cotton producers. Any reduction in the price paid for cotton will discourage cotton farming and hamper cotton-based exports, a market in which Pakistan has only recently become competitive. I am confident that the authorities will find other ways to increase revenues and focus their exports on the higher value-added sectors.

Concerning the authorities' supply policy, I welcome their intention of liberalizing the economy by removing unnecessary controls, and I encourage them to broaden that effort. I urge the authorities to abolish the system of investment licensing as they proceed to liberalize trade. Otherwise the existence of nontariff barriers will direct future investment mainly toward import-substitution sectors, where imports are already physically restricted by the system of import licensing.

Finally, I do not share the staff's views on exchange rate policy. The premium on foreign exchange bearer certificates arises from the restraints on current transactions, rather than from the pressure of exchange rate expectations. Thus, this premium cannot be used as an indicator of pressures on the exchange rate until the import regime and current transactions are further liberalized, a step that I believe is the only way to promote export growth.

Mr. Grosche made the following statement:

Since I can endorse the thrust of the staff appraisal, I will restrict my remarks to a few policy areas where I feel that stronger actions would greatly benefit Pakistan's economy.

First, more forceful action is urgently called for in the fiscal area. Performance has weakened in recent years, and as the staff explains in the supplement to the staff report, the outlook is less than bright. Even though the targets for both current and investment spending have been scaled down, the budget proposed for 1987/88--and approved by the National Assembly--aims at a fiscal deficit to GNP ratio of 7.6 percent. This ratio is similar to the original budget target for 1986/87--a target that subsequently has been largely overshot, resulting in a quite substantial recourse to the domestic banking system to finance it. Accordingly, an overshooting of the deficit target for 1987/88 cannot be excluded. The staff indicates that the additional tax measures may not generate as much revenue as expected. Moreover, these measures do not seem appropriate from another perspective, as they put an additional burden on international trade and do not appear to be in line with the proposals made by the National Taxation Reform Commission. As far as I can see, almost none of these proposals have been taken up. I refer in particular to the proposed introduction of an across-the-board single-rate sales tax, which seems slow to be implemented, even though this measure is viewed as a particularly promising avenue for raising additional income. It is also worrisome to note that manufacturing continues to be overtaxed, compared with agriculture. I take it from the staff report that, unfortunately, the taxing of agricultural income also remains an unresolved issue in the coming fiscal year.

On the expenditure side, I join the staff in urging the authorities to take additional measures aimed at reducing the growth of current expenditures, particularly subsidies. As the staff notes, subsidies have continued to expand in several areas, not only putting a substantial burden on the budget, but even more regrettably, impeding possibilities for higher economic growth and export diversification.

This leads to the second area where I feel more has to be done: the external economy. Despite the welcome fact that the overall external account has been more or less in balance during the past two years, Pakistan's external position remains weak. The trade accounts show a high deficit; exports rely heavily on agricultural products and on cotton-based manufactured goods, which are faced with strong competition on world markets. The current account balance is affected by volatile workers' remittances. Moreover, as amply illustrated by the staff, the external reserves position has weakened and debt service payments have been rising rapidly. I take it from Mr. Finaish's opening remarks that the current policy stance will not continue. However, if it were to continue, the first medium-term scenario shows that the current account will weaken quite substantially during the next few years. I therefore join the staff in urging the authorities to continue a flexible exchange rate policy and to liberalize speedily the external sector. In this regard, I welcome the recent measures described by Mr. Finaish, and I hope that these will be followed soon by further steps.

Finally, I urge the authorities to continue--and wherever possible, to strengthen--the process of reducing state interference with the private sector. I have noted the recent measures taken to enhance the supply side of the economy. However, more has to be done to deregulate the economy, particularly to strengthen price incentives. Such a policy eventually will result in higher output. The growth of per capita income, however, depends also on the growth of the population, which--as Mrs. Filardo has mentioned--has been estimated by the authorities at 3 percent a year--a deeply worrying figure, indeed. In conclusion, I support the proposed decision.

Mr. Foot stated his strong agreement with the staff assessments in the staff report and the supplement. The fiscal position was rapidly becoming untenable. It had been kept afloat thus far by large and costly borrowing; Table 2 of the staff report, for example, showed that the percentage of total revenue being absorbed by interest payments had nearly doubled in the past seven years. He accepted that political and social pressures made it difficult to tackle the problem, as had been demonstrated recently by the reception given to the original 1987/88 budget proposals, but the authorities had no alternative but to continue trying. Otherwise, there would be an unreasonable burden on monetary policy, requiring high interest rates that would greatly damage the private sector. Moreover, there would be little prospect of reducing the external financing gap to a size that could be filled on sustainable terms, or of opening up the economy, which was much needed. On that last point, the new trade policy changes introduced on June 29 represented a welcome, modest step, but much more was needed.

The urgency of those problems was shown by the staff's medium-term balance of payments projections (Table 8, Appendix III, SM/87/137, 6/22/87), Mr. Foot continued. Under the first scenario, in which the current policy stance was to be maintained, 1987/88 promised to be quite a difficult year even if aid flows were as high as hoped. As demonstrated by the recent experience of one European country, it was also important to note that workers' remittances could diminish quickly if serious doubts emerged as to the viability of the authorities' policies.

He could draw some comfort, as Mr. Finaish had, from the events of recent years, and the economy of Pakistan clearly had elements of distinct robustness, Mr. Foot added. Those factors, combined with the authorities' awareness of the problems facing them, were encouraging. Finally, he supported the proposed decision.

Mr. McCormack made the following statement:

We are encouraged by the strong record of economic growth that Pakistan has achieved during the past few years. The authorities' task in bringing about a major structural transformation in the economy is made difficult, however, by uncertainties with regard to such factors as workers' remittances and commodity prices. This vulnerability to developments outside Pakistan's control highlights the importance of promoting liberalization and structural change to ensure a more stable pattern of economic growth in the future.

In this vein, the progress that has been made in eliminating price controls and reducing explicit subsidies is a positive step toward long-term economic growth. Where enhanced producer price incentives have been used, economic benefits have materialized. However, as the staff points out, recent initiatives by the authorities often have involved continued constraints on private sector involvement, indicating perhaps a degree of ambivalence about deregulation and the goal of enhanced market orientation. We concur with the staff that the authorities have indeed been pursuing deregulation in measured steps. We feel that Pakistan's future growth potential will be limited by excessive government intervention, and we urge the authorities to accelerate their withdrawal from involvement in the marketplace.

While we are encouraged to note that the recently approved 1987/88 fiscal budget incorporates a reduction in the overall deficit from its current level of 8.8 percent of GDP to 7.6 percent of GDP, we share the staff's doubts about the budgetary outlook. Given the poor fiscal performance in recent years and the apparent difficulty of increasing revenue substantially in the short run, recently demonstrated by the authorities' withdrawal of the defense tax in response to domestic political pressure, the deficit reduction measures on which these targets are predicated may be difficult to realize. To escape this pattern of having to impose, almost every year, increasingly unpopular discretionary taxes on a narrow tax base, decisive steps are called for to broaden and increase the elasticity of the tax base. In this connection, a high priority attaches to the early implementation of the proposals of the National Taxation Reform Commission. A durable improvement of the budgetary position will also require that revenue enhancement be complemented by rigorous expenditure evaluation and control, to ensure that government spending grows at more sustainable rates than in the recent past.

In the absence of a comprehensive revenue effort this year, the authorities will be forced to look again to domestic nonbank private savings, in addition to external sources, to finance the fiscal deficit. The external debt load is already high, with debt service payments usurping 28 percent of current receipts. Further recourse to the domestic nonbank private sector will result in an increased cost of servicing the public debt, as the Government has had to turn increasingly to high-cost borrowing instruments in order to attract sufficient funds. There seems to be substantial risk of "crowding out" private sector investment if this process is maintained.

We support the direction of the trade initiatives announced by the authorities and note that they will apply for the next three years. This may provide some scope for long-range planning. However, we hope that the desire for stability will not give rise to rigidity and, in particular, that the implementation of further measures of liberalization will not be delayed unnecessarily, whenever they are judged to be practicable and desirable. We commend the measures to remove 136 items from the "negative" list of imports and the duty-free importation of cotton yarn. However, Pakistan's trading system remains heavily regulated and complex. In particular, the reliance on quantitative restrictions as opposed to tariffs, and the increase in countertrade agreements, represent significant obstacles to efficient export-led growth and import substitution.

We support the staff view that further flexibility in exchange rate management is required to improve the performance of nontraditional exports and broaden the export base. It is encouraging to see the reduction in the current account deficit that is forecast in relation to GDP, but the excessive reliance on workers' remittances and agricultural and cotton-based manufactured exports renders the underlying framework of the balance of payments structurally weak and vulnerable. Increased flexibility in exchange rate management will strengthen the export base and ultimately result in an improvement in the currently weak international reserve position.

Finally, there are grounds for encouragement in Pakistan's recent economic performance and in the authorities' adjustment efforts. We encourage the authorities to intensify their efforts in the years ahead.

Mr. Vasudevan made the following statement:

The staff report makes it clear that Pakistan's economic performance during the 1980s has been commendable. Apart from recording high real growth rates, the country has also experienced an improvement in the inflationary situation. An achievement worthy of special mention is the strong expansion in domestic crude oil production. The staff appraisal essentially concentrates on two main themes: first, the need for Pakistan to bring about structural changes, and second, the need for the authorities to bring about a reduction in the fiscal deficit and to effect an orderly fiscal adjustment.

Very few of us would have any problem with the suggestions for structural reforms in any economy, irrespective of its stage of development. However, some concerns remain, mainly those relating to the pace of acceleration and the timing of reform measures. Mr. Finaish has correctly pointed out that structural adjustment in low-income developing countries requires considerable time--a "multiyear effort," as he calls it. He has detailed in his opening remarks the various steps taken by the authorities to promote structural changes. These measures are intended to enhance agricultural productivity, decontrol wheat prices and trade, eliminate the government monopoly on edible oil imports, open the Basmati rice trade to the private sector, increase producer prices of crude oil, increase privatization or divestiture, bring about financial deregulation, and liberalize imports through the removal of many items from the negative list. Since the issuance of the staff report, the authorities have announced a trade policy for a three-year period, thus reflecting the stability in policies. These are welcome developments. The productivity of investment seems to have been maintained at levels that have ensured high growth rates in the manufacturing sector, but this should not prevent the authorities from continuing to mobilize additional resources and promote the efficient use of resources.

The staff argues that the high fiscal deficits will have an adverse effect on financial stability and on the balance of payments. We agree that the deficits have grown substantially during the 1980s, from 5.3 percent of GDP in 1981/82 to 8.8 percent in 1986/87. However, it is of interest that even as the fiscal deficits have been growing in the recent past, inflationary pressures have moderated and gross domestic fixed capital formation in the private sector has risen. The current account deficit has remained more or less at the same level in relation to GNP. This evidence notwithstanding, it must be recognized, as Mr. Finaish has argued, that fiscal problems in low-income countries are essentially structural in nature, and that it is unrealistic to expect rapid changes. Mr. Finaish has also pointed to the huge refugee problem, rising interest payments, and defense outlays as constraints in the reduction of current expenditures. These are important elements to be recognized. Nevertheless, we see the point made by the staff that tax receipts are dependent, to a large extent, on foreign trade. In this context, we found the recommendations of the National Taxation Reform Commission report useful and interesting. Pakistan's tax revenues as a proportion of national income have not been as high as in many other low-income countries, and there appears to be some scope for improving revenue performance in this regard.

In the 1987/88 budget, the authorities have made a good attempt to reduce the size of the fiscal deficit. In this budget, it is the nontax revenue that seems to provide larger receipts than the tax revenue, while expenditure declines are due mainly to large cuts in subsidies. It is too early to assess whether the targeted fiscal performance will materialize in 1987/88. The staff, however, indicates that it will be difficult to achieve the targets, without giving enough details of the reasons for such an assessment, and some additional clarifications in this context would be useful. The supplement to the staff report gives the impression that the authorities are in the process of reviewing the tax policies.

A point about the fiscal developments: while the background paper has provided much useful information, it would have served us well had there been a technical analysis of the elasticity of the tax system, as well as details of some of the expenditure items such as defense and refugee rehabilitation. The points made by the National Taxation Reform Commission relating to the value-added tax could also have been presented in more detail, to whet our appetites.

We agree with the staff's major suggestion that comprehensive structural reform is needed to meet the financing gaps in the balance of payments in the medium term. The authorities' recent announcement of import and export policies for a three-year period is a step in the right direction. We generally agree with the authorities' caution in liberalizing imports, given the uncertainties of economic developments abroad, including protectionism, and the structural aspects of the external sector. We also find the approach to exchange rate management flexible. The staff argues that "more discretionary adjustments" to the rupee/U.S. dollar rate appear to be needed to overcome the inertia displayed by noncotton-based manufactured exports in recent years; this argument gives the impression that the real effective exchange rate can depreciate further, and that the effectiveness of the exchange rate should be seen with reference to the buoyancy in nontraditional exports. Table 69 in Appendix III of the background paper shows that the trade-weighted real effective exchange rate has in fact declined substantially; the relative real exchange rate index dropped from 68.7 in the first quarter of 1986 to 58.5 in the first quarter of 1987. Therefore, we do not see a need for any further depreciation.

Finally, we support the proposed decision.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/87/114 (7/31/87) and EBM/87/115 (8/3/87).

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 86/197 and 86/198 are approved. (EBD/87/202, 7/27/87)

Adopted July 31, 1987

APPROVED: March 2, 1988

LEO VAN HOUTVEN
Secretary