NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 90/151

10:00 a.m., October 22, 1990

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	Z. Iqbal, Temporary
G. K. Arora	L. E. N. Fernando
	D. Powell, Temporary
	Shao Z., Temporary
	S. B. Creane, Temporary
J. de Groote	F. Moss, Temporary
	J. M. Jones, Temporary
E. A. Evans	
	P. O. Montórfano, Temporary
	A. Napky, Temporary
	A. Fanna, Temporary
	M. A. Ahmed, Temporary
M. Fogelholm	
	S. Rouai, Temporary
	B. Goos
J. E. Ismael	
	G. Bindley-Taylor, Temporary
	J.-L. Menda, Temporary
	G. Serre, Temporary
	C. V. Santos
	K. Kpetigo, Temporary
	P. Wright
	G. P. J. Hogeweg
K. Yamazaki	

C. Brachet, Acting Secretary
B. R. Burton, Assistant

<u>Also Present</u>

IBRD: V. Rosenthal, Africa Regional Office; H. Shishido, Asia Regional Office. African Department: M. Touré, Counsellor and Director; E. A. Calamitsis, Deputy Director; C. P. Andrade, J. R. Hill, J. M. Jiménez, E. Mendoza, J. Santos. Asian Department: P. R. Narvekar, Director; K. Saito, Deputy Director; M. W. Bell, J. R. Dodsworth, M. B. Rose, W. M. Tilakaratna. Exchange and Trade Relations Department: T. Leddy, Deputy Director; M. V. Carkovic, M. E. Edo, A.-M. Gulde, S. Kanesa-Thasan, P. Mylonas. External Relations Department: A. Mountford. Fiscal Affairs Department: S. Gupta. Legal Department: D. Akrofi-Asiedu, P. L. Francotte, R. B. Leckow. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: W. L. Coats. Advisors to Executive Directors: H.-J. Scheid, S. P. Shrestha, A. M. Tanase. Assistants to Executive Directors: C. Björklund, B. A. Christiansen, H. E. Codrington, E. C. Demaestri, S. Gurumurthi, K. Ichikawa, K. Ishikura, C. J. Jarvis, L. I. Jácome, D. Saha, C. Schioppa, M. J. Shaffrey.

1. SRI LANKA - 1990 ARTICLE IV CONSULTATION; AND STRUCTURAL ADJUSTMENT FACILITY - THIRD ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1990 Article IV consultation with Sri Lanka, together with Sri Lanka's request for a third annual arrangement under the structural adjustment arrangement approved on March 9, 1988 (EBS/90/167, 9/24/90; Cor. 1, 10/18/90; and Sup. 1, 10/19/90). They also had before them a background paper on recent economic developments in Sri Lanka (SM/90/192, 10/10/90), a policy framework paper for the period 1990-93 (EBD/90/307, 9/24/90), and a statement by the Managing Director.

The Managing Director's statement read as follows:

> There follows for the information of Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Committee of the Whole of the Executive Directors of the Bank and IDA in their meeting on October 16, 1990:
>
> The Committee commended the Government's commitment to economic reforms over the last year, which was an exceptionally difficult period politically for the country, and its efforts to stabilize the economy. The Committee noted that the Government's medium-term structural adjustment program aimed at reducing the size of the public sector and increasing its efficiency; providing a more favorable environment for private sector investment and output; and helping cushion the poor from some of the costs of adjustment, including employment consequences. It noted, however, that much remains to be done--especially in terms of further structural adjustment and curbing a high rate of inflation--and urged the Government to maintain the course of the reform program. More specifically, the Committee raised the following issues:
>
> First, with respect to macroeconomic management, the Committee welcomed the Government's sound macroeconomic management stance which enabled them to maintain fiscal and external deficits in 1989 which were much lower than the targets under the second-year program and to achieve a turnaround in economic growth. Many speakers stressed that continued fiscal stability is the key to sustainable growth. In this regard, public expenditures-- particularly recurrent expenditures--should remain tightly controlled and the proposed tax reforms acted upon. Some speakers expressed concern that the crisis in the Middle East increased internal security expenditures, and devolution of functions to the provincial councils could put added pressures on the fiscal deficit. The Committee also welcomed the tight monetary and credit stance adopted by the Government to reduce inflation. It referred to weaknesses that had

developed in the financial sector and the need to take corrective measures to improve the level of loan recoveries and to privatize the state-owned banks.

Second, some speakers emphasized the importance of growth of the productive sectors as sources of employment and incomes. In agriculture, stress was laid on diversification policies, improvements in land ownership and water resource management, and restructuring of the plantation sector. An improved policy environment for the private sector would be important to ensure sustained growth in agriculture and export-led industrial investment.

Third, the Committee emphasized that a smaller and more efficient public sector will be critical to the success of the Government's economic reform efforts. In this context, several speakers also urged the Government to maintain the pace of administrative reform, although its difficulty, particularly in managing the retrenchment of redundant staff, was well recognized. The Committee also welcomed the ongoing efforts to privatize and/or commercialize public manufacturing enterprises and divest the public sector bus companies.

Fourth, the Committee was concerned that structural adjustment efforts during this difficult period may adversely affect the well being of the poor, and exacerbate the unemployment problem. It welcomed the Government's efforts--with IDA assistance--to retarget the country's welfare programs to the truly needy and to make the programs more production and employment oriented. The Committee--noting that not only would the revised programs improve the welfare of the poor, but also would help address the problem of malnutrition among children--suggested that they be initiated as soon as possible. The Committee stressed the importance of ensuring continued support for human resource development programs. It also stressed that the benefits of existing social sector programs should effectively reach the groups most affected by the adjustment process.

The Committee expressed its sympathy with respect to the difficult situation Sri Lanka is facing as a result of the crisis in the Middle East and observed that the restoration of domestic tranquility would be critical for the success of the reform program. It supported IDA's efforts to mobilize additional quick-disbursing assistance through aid coordination--in particular, at the forthcoming Aid Group Meeting in Paris--and also IDA's own intention to provide special assistance to help mitigate the effects of the crisis.

Mr. Fernando made the following statement:

The policy framework paper (PFP) and the structural adjustment facility (SAF) processes have provided the medium-term framework for Sri Lanka's adjustment path to be charted and monitored in recent years. My authorities are highly appreciative of the collaborative role played by the staff in designing the economic programs and the continuing technical support to strengthen sectoral policies toward the achievement of macroeconomic objectives.

Last year, when seeking a resumption of Fund assistance through the second annual arrangement under the SAF for the stalled adjustment process, the Sri Lanka Government attached primary importance to a sound track record of program implementation. In the weeks that preceded approval of that arrangement, resolute action--through a large discrete devaluation and tight monetary policy actions to stem the rapid deterioration in economic and financial conditions--was a down payment in this regard. Directors would recall that at the time of the request for the second annual arrangement under the SAF, the staff paper drew attention to the risks to the program on account of civil unrest and unsettled political conditions--risks of the kind that overwhelmed the first annual arrangement. But, parallel and firm action on the security front resulted in an abatement of tensions and the restoration of law and order in most parts of the country.

Although the trend of diminishing risks during the second annual arrangement under the SAF was broken by some recent events, these have by and large been contained to areas peripheral to the economic heartland. Obviously, to the extent total normalcy is elusive, the economy will not yield its full potential. Besides, the reconstruction imperatives in such areas after normality returns can boost output and employment as strong financial support is assured through undisbursed concessionary external finance. For the present, however, the marginalization of the areas of conflict and easing of tensions have provided a welcome latitude for policymakers to devote primary attention to the task of economic policy and management.

The large financial imbalances and the precarious external reserves level, which were the immediate targets of the stabilization focus in the second annual arrangement under the SAF, rapidly improved as the economy and economic agents responded to the confidence-building stance of government policy. Financial tightening beyond that contemplated in the program resulted in budgetary, balance of payments, and external reserves targets being exceeded by wide margins. The unexpectedly strong rebound in the economy, reflected in output growth in agriculture and a surge in tourist arrivals, served to promote domestic consensus in the reform measures and thereby reinforced and helped sustain the adjustment efforts.

The imperatives of staying within the adjustment path have led the authorities to adopt a pragmatic approach with respect to the policy mix, as well as to be alert to grasp opportunities for timing certain actions. Therefore, to reach fiscal objectives for 1989, across-the-board cuts in nonwage and noninterest expenditures were enforced. To dampen monetary expansion quickly, the authorities temporarily resorted to direct credit controls. When it was apparent that procedural delays were hampering the imposition of excise taxes on additional products, the authorities protected the revenue target through additional measures, including higher levies on existing excises and surcharges on duties on luxury imports. Pending amending legislation, administrative means were employed to rescind the 100 percent transfer tax on equity share sales involving foreigners--a tax which was an impediment to foreign investment. In a very recent move to reduce fuel consumption in the wake of the Middle East crisis, the Government, in addition to the full pass-through of higher oil costs, has imposed cash limits on departmental fuel costs.

The importance of timing in eliminating budgetary subsidies--especially with respect to price adjustments of essential commodities and services--cannot be overemphasized. During the program period, general commodity subsidies were ended through successive steps. In the most recent action arising from the adjustment to higher international oil prices, both bus and rail fares were increased after nearly eight years of administrative control. Raising the bus fares, as a prelude to complete deregulation shortly, will further hasten the impending privatization of the large state transport agency.

The priority for stabilization at this stage is inflation control. At 20 percent on an annual basis, inflation in 1990 is running at nearly double the level programmed in the PFP. My authorities are acutely conscious of the need to bring inflation under control. Inadequately tackled, it could undermine domestic and foreign business confidence and throw the program out of gear.

The sharp depreciation of the rupee at the commencement of the program and price adjustments of several key commodities to eliminate subsidies contributed to domestic inflation. Being one-time measures, and accompanied by monetary tightening, the price situation should have moderated with a suitable lag after adjustment actions were completed. The fact that inflation has taken deeper root suggests the presence of other factors. Therefore, the Government has accorded high priority to deepening financial sector reform. The steady reduction of the remaining distortions and the greater reliance on market mechanisms in the pursuit of monetary policy should facilitate a sustained reduction in inflation and inflationary expectations.

At last year's consultations, much stress was placed on increasing economic efficiency through reforms in public enterprises to make them more commercially oriented. In this context, many Directors indicated that the pace of privatization should be accelerated. The staff paper sets out in detail the progress made in this area. It would indeed seem that the thrust of structural reform has been reform and privatization of public enterprises and the authorities have demonstrated their commitment to a leaner and more efficient public sector. Technical and financial support received from the World Bank have eased this process. It is to be noted that in consideration of the limited absorptive capacity of the domestic capital market, commercialization of operations of a wide range of public enterprises is regarded a prelude for an eventual successful privatization. This process has received a boost from the Government's efforts to attract foreign investment directly into the privatization process.

The authorities are very sensitive to the urgent need to provide an impetus to human resources development. Reasons of budgetary stringency and a large project-oriented public investment program in the past few years had pared outlays in health care and education to the point where Sri Lanka's renowned achievements in this area were looking fragile. Continued prudence in budgetary policies and the continuing rationalization of public investment outlays will serve to catch up lost ground and strengthen human resources development.

Closely related to this concern is the Government's social safety net to protect the poorest and vulnerable groups who are the most adversely affected during an adjustment process. Restructuring public finances and reducing price distortions have entailed the elimination of various subsidies. As a result, prices for certain basic necessities increased sharply. However, the authorities now have sufficient latitude to improve targeting, with an emphasis on direct transfers to the poor. Targeting has been sharpened additionally through community participation in identifying eligible recipients. While the staff papers set out further steps in the coming months, it is to be highlighted that the Poverty Alleviation Program is being developed into a more production- and employment-oriented one.

The Government accepts primary responsibility for the reduction of poverty. But significant progress requires that their efforts be complemented by appropriate policies in industrial countries and by strong donor and creditor support. The sound macroeconomic and structural reform policies of the Government provide a suitable medium-term framework for concessional external support for Sri Lanka's balance of payments. Such financing is crucial to bring about the necessary growth orientation to the economy. Without this, neither a poverty policy nor equity concerns could be satisfied on a sustainable basis.

The stabilization measures undertaken so far have strengthened external reserves and the balance of payments. But the events in the Middle East have underscored the vulnerability to external factors. Apart from the very high levels and uncertainty attached to the oil price, real income, savings, and the balance of payments are being eroded by the disruption to tea exports--the Middle East being the main market--and reduction in worker remittances. The ensuing losses, although initially estimated at 1 percent of GDP, are now more likely to reach 2 percent for a full year. The Government also has to look after the repatriation and resettlement of the massive numbers of its citizens who have been displaced. Directors will note that the Government acted swiftly to protect the adjustment program by passing down oil price increases to final users.

Without the debilitating effects of a debt overhang--a consequence of the prudent external debt-management policy of the past--and a low debt-service ratio, Sri Lanka has the opportunity for a strong push toward balance of payments viability on a sustained basis. Concluding action on trade liberalization, by way of simplification of the tariff structure into four bands, lies ahead, with the timing affected by revenue considerations to keep public finances within the adjustment path. In a significant operational move by the Central Bank, there is much greater transparency of the impact of market conditions on the exchange rate. My authorities believe that the progress made so far in building up the macroeconomic environment and the high level of articulation of structural reform should open the door for an arrangement under the enhanced structural adjustment facility.

Mr. Yamazaki made the following statement:

Although Sri Lanka experienced some difficulties in achieving its adjustment objectives in the first year of its arrangement under the SAF, the authorities fully restored the adjustment momentum by pursuing prudent financial policies despite the difficult security conditions. It is worth noting that the determined implementation of the incomes policy, including subsidy elimination and devaluation, has substantially improved macroeconomic prospects. I was impressed by the fact that the authorities have achieved their adjustment objectives by adopting responsible supplementary measures, despite the civil disturbances.

Subsequently, with the improvement in the security situation, all the program benchmarks have been met with wide margins through June 1990. In particular, renewed strong growth in output and external capital inflows are quite significant; they have contributed to improving the environment for further deepening the structural adjustment.

This being said, caution is warranted with regard to inflation, as the staff report rightly points out. While the inflation rate decelerated somewhat in August--to 20 percent from a peak of 27 percent--the current rate appears to be unsustainably high. In this connection, the fiscal burden associated with the worsening security conditions in the North, along with their negative impact on confidence in the economy, is a source of concern. In addition, the Middle East crisis has added considerable costs to the economy in many respects. It is heartening to note, however, that the authorities have responded promptly to external adverse shocks by tightening their incomes policy. Nevertheless, the remaining structural impediments, particularly the inefficiency of the public sector, have to be addressed in order to achieve noninflationary growth over the medium term, because not only are they imposing a fiscal burden, but also are creating supply-side bottlenecks.

All in all, the challenges facing Sri Lanka are still formidable. However, as Mr. Fernando said in his statement, the authorities should attach priority at this stage to containing price increases and safeguarding external viability, as price stability is an essential condition for furthering strong structural adjustment measures. In my view, the gradual appreciation of the real effective exchange rate, which has not paralleled the nominal rate movement since the last devaluation, is a source of concern. A reduction in inflation is a matter of urgency. To this end, the firm implementation of tight fiscal and monetary policies is called for.

Let me touch on the problem of inflation, which has been high since the end of 1989, before I discuss the specific policies comprising the proposed annual program. The staff report seems to attribute the rapid price increases mainly to the devaluation of the rupee and the elimination of subsidies. However, these factors should have only a one-time effect on prices. In my view, the prolonged price increases suggest that the structural rigidities in the economy have amplified the effects of the relative price adjustment. I also wonder whether wage developments did not play a moderating role. I would welcome the staff's comments on these points. In this connection, targets for the reduction in the inflation rate envisaged under the program--namely, 16.5 percent by the end of this year and 10 percent by the end of 1991--seem to be somewhat too modest. Needless to say, sustained price increases would distort resource allocation and make the adjustment burden harder at a later stage. Furthermore, in view of the success in reducing the inflation rate in August, despite the adjustment of the domestic oil price, I wonder whether it would be feasible to lower inflation more rapidly in the period ahead by tightening financial policies.

This brings me to the importance of fiscal adjustment. In the past year, the authorities reduced subsidies and other current expenditures rigorously. This being said, I agree with the staff that, under the new budget, the adjustment burden should continue to be borne by expenditure curtailment. In particular, restraint over current expenditure, including the wage bill, social welfare, and defence expenditure, would be crucial. On the other hand, cautious management of capital expenditure is also important. The profitability of projects should be examined and priorities established in the investment program. On the revenue side, while I can endorse the basic orientation of the tax reform plan, caution is warranted in its implementation in order to avoid a revenue shortfall. As the restructuring of the Ceylon Transport Board (CTB) and other public enterprises will impose an additional fiscal burden on the budget, prudent fiscal management will be necessary throughout the year.

On the monetary front, the pace of liquidity growth in the first half of 1990 has been on the high side. Credit tightening was somewhat delayed, which partly contributed to the rapid price hikes. I would encourage the authorities to adhere to the monetary targets set for the remaining period of the program. In addition, however, I agree with Mr. Fernando that much needs to be done to enhance the efficiency of the financial sector. While I can endorse the retention of direct credit control at this stage, a market-oriented monetary policy should be established over the medium term in view of the vulnerability of current prices. Full liberalization of interest rates and a review of the refinancing rate will be key elements in this context. In this connection, parallel efforts to strengthen the financial viability of the banking sector, particularly the dominant state-owned banks, are important.

On the structural front, although I welcome the significant progress made so far, I would encourage the authorities to accelerate public sector reform--including privatization--to take advantage of the current favorable economic circumstances. In particular, restoring the financial health of the public enterprises through the rationalization of labor and the adoption of an appropriate pricing policy is important. The improvement of operational efficiency is an essential condition of smooth and successful privatization. In addition, I welcome the authorities' decision to introduce foreign direct investment into the privatization process in recognition of the limited domestic capital market. These efforts, together with trade liberalization, would enhance the efficiency of the economy. However, I should add that the timing of their implementation will be critical in maintaining external competitiveness in the face of the recent adverse external shocks.

Finally, let me comment briefly on exchange rate policy. As I noted earlier, the major devaluation in 1989 contributed to the revival of the external sector of the economy. This being said, the real effective rate has been under pressure ever since. I am somewhat concerned that real appreciation, if it continues, may make it difficult to implement the new exchange rate policy. Although I can endorse the introduction of market-oriented exchange rate determination, it should be underpinned by tight domestic financial policies. In my view, a more significant contribution to external competitiveness could be expected through structural adjustment.

I could not agree more with the staff that the medium-term prospects depend crucially on the duration of the internal security problem. In view of the large financing gap over the medium term and, more importantly, in light of the authorities' close collaboration with the Fund, continued Fund assistance beyond the current SAF program, as well as international cooperation, seems warranted. However, such external assistance crucially depends on the adjustment performance under the current program, as well as on the authorities' efforts to eliminate potential impediments to the implementation of strong adjustment policies--the security problem, in particular.

With these remarks, I fully support the proposed decision.

Mr. Wright made the following statement:

Let me also start by congratulating the Sri Lanka authorities on meeting all the quantitative and most structural benchmarks in the second year of their program by large margins, despite the difficult domestic situation. The timely response to domestic budgetary slippages and prudent financial policies adopted in 1989 improved confidence in the management of the economy and paved the way for a recovery in output, a reversal of capital flight, and an improved current account position.

However, this encouraging performance has been marred by a sudden surge in inflation. Unless it is brought under control quickly, it will undermine competitiveness and delay a return to the sustainable growth on which the authorities' social objectives depend. The authorities must ask themselves some searching questions about why monetary policy was eased at the beginning of this year, when output was growing at a respectable rate and at precisely the time when the effects of the 1989 devaluation on domestic prices needed to be most vigorously contained. I suspect that the authorities underestimated not only the inflationary effects of a sudden depreciation, but also the pent-up demand in the private sector that was released once uncertainty about the domestic situation began to disappear. The main challenge facing the authorities now is therefore to reduce inflation before a damaging wage-price spiral becomes entrenched and undermines the renewed confidence in Sri Lanka's stability and its still-fragile external position--far greater dangers than a temporary period of slower output growth while inflation is brought under control.

Much of the burden of achieving lower inflation will necessarily fall on monetary policy. One very encouraging development is that the Government's own contribution to monetary growth, in the form of borrowing from the banking system, will be modest this year and negative next year--a welcome development. Credit growth to the private sector, on the other hand, has grown strongly, and I am bound to say that the projected growth of around 17 percent this year and in 1991 looks somewhat generous. The restraint of credit growth will clearly require higher interest rates; these rates should be raised to levels which are positive in real terms as quickly as possible. More generally, I would also join the staff in urging that the authorities move rapidly to adopt indirect methods of monetary control. Finally, a further depreciation of the exchange rate would be unhelpful until inflation has been brought, and can be kept, under control. As Mr. Yamazaki has already noted, the real exchange rate has risen recently--a reflection of the surge in domestic inflation. In my view, any attempt to compensate by means of a nominal depreciation would be inappropriate and counterproductive at the current juncture.

The need to reduce inflation adds urgency to the authorities' attempts to tackle the budget deficit and the inefficient public sector, the Achilles' heel of the Sri Lanka economy. The reduction of the budget deficit in 1989 from 15.6 percent of GDP to 11 percent provides a good basis for further progress in reducing the deficit to well below double digits figures. I would hope that the authorities could once again better the fairly modest reduction projected for 1991, to allow even more substantial repayments of bank borrowing than are currently projected. The removal of wheat, fertilizer and rice subsidies and the prompt pass-through of higher oil prices are promising signs of their commitment. The authorities might be wise not to rely too heavily on the anticipated reduction in defense spending or on wage restraint. If these savings materialize, they will provide a bonus, but both are to some extent outside the authorities' direct control. Difficult decisions cannot be avoided in areas such as welfare spending which, although clearly of enormous importance to much of the population, could probably be better focused. Clearly, the authorities need to pursue more energetically reductions in the size and cost of the civil service; so far, attempts to address this problem have only scratched the surface. I am concerned that the authorities' strategy of a hiring freeze plus voluntary redundancies may not result in a civil service of the optimum skills and calibre. I would prefer both a more selective and a faster and more thorough approach to civil service reform, even though it would undoubtedly be more difficult and painful in the short term.

Understandably, the staff have focused largely on the scope for reducing expenditure, but I doubt whether the authorities have exhausted the possibilities for broadening the tax base in ways that would both simplify the system and bring in additional revenue that would allow import tariffs to be reduced at a faster rate. Perhaps the staff could comment. It is certainly imperative that any changes to the tax system are at least revenue neutral.

Much more needs to be done to open the Sri Lanka economy to market forces if its optimal growth rate is to be achieved. Some progress has been made. But the financial sector remains dominated by state-owned, financially weak institutions, and intermediation costs are high. Import tariffs need to be reduced. There are still far too many enterprises in the public sector, whose inefficiencies are tolerated at the expense of taxpayers and consumers. A more commercial approach to running them needs to be adopted to pave the way for eventual privatization.

Finally, the paper notes that Sri Lanka is one of the countries most vulnerable to the Middle East crisis, as it is affected by not only higher oil prices, but also lower remittances, resettlement of migrant workers, and frozen debts owed by Iraq. I wonder whether the staff could give some indication of the scale of these effects and indicate how the authorities can respond to ensure that the program remains on course.

With those comments, I can support the draft decisions, with the hope that the significant and commendable improvement in policy implementation in the past year will be sustained.

Mr. Ismael made the following statement:

I would also like to commend the Sri Lanka authorities for their perseverance in the implementation of their adjustment program under the second year of the arrangement under the SAF. Their efforts were all the more commendable given the difficult domestic political situation which they faced. The fruits of their labor were evident in the remarkable improvement in the country's macroeconomic performance, and in the observance, with wide margins, of all quantitative benchmarks through June of this year.

However, developments on the inflation front were disappointing. The climb in the inflation rate to over 20 percent in the middle of this year from a single digit rate in early 1989 is, of course, a cause for serious concern. Such high levels of inflation, if left unchecked, will certainly jeopardize the economic recovery and threaten the gains achieved, particularly in the fiscal and external sectors. The authorities' recognition that the containment of inflation is a priority in their stabilization efforts is, therefore, reassuring. In order that inflationary pressures can be reduced to achieve the inflation target of 10 percent by end-1991, as envisaged under the program, it is imperative that domestic financial policies remain tight.

Rightly so, fiscal restraint remains the cornerstone of the program's macroeconomic strategy. It is important that the authorities adhere closely to the program targets. As revenues could not be relied upon to achieve the reduction in the fiscal deficit, expenditures have been burdened with this task. In this respect, the authorities must be steadfast in implementing the planned reduction in current expenditures, which include subsidies, personnel expenditures, and restraint in welfare programs. Prompt action on the part of the authorities to introduce compensating fiscal measures in the event that the fiscal program is seen to be heading off track is certainly crucial, so that the overall adjustment program will not be threatened.

Efforts to contain inflation must undoubtedly include a tight monetary policy. Liquidity growth, which has been quite rapid recently, needs to be reduced. The recent increase in nominal interest rates and the projected further increases are an appropriate measure to achieve positive real interest rates, which will help to contain credit expansion and to absorb excess liquidity. I can sympathize with the authorities on the need to maintain direct credit controls, but I would urge that they press ahead with reform of the financial sector, so that monetary policy can be implemented through the use of indirect, market-related instruments.

It is also imperative that the productive capacity and efficiency of the economy be raised. Therefore, the authorities should press ahead with their reform efforts to improve the environment for trade and industry. The privatization of public enterprises should be speeded up. The Government's plan to reduce bureaucratic impediments to business activity is a welcome step, although an adequate set of incentives, to my mind, is also essential. Meanwhile, the measures to liberalize trade are a step in the right direction, and the reform efforts in public employment and expenditure should be continued earnestly.

The Sri Lanka authorities have shown perseverance in their adjustment efforts, and their commitment was recently demonstrated by the actions they adopted in response to the developments caused by the Middle East crisis, that is, the pass-through of oil price increases to consumers and the tightening of financial policies. Therefore, I have no difficulty in supporting the proposed decisions. In concluding, I would like to caution the authorities that since their economic prospects are very susceptible to adverse external developments, there is no room for slippages, and the authorities must continue to stand ready to adopt new measures in the face of any deviations from the program path.

Mr. Iqbal made the following statement:

It is gratifying to note the significant progress made by Sri Lanka during the past year in moving toward sustainable economic growth. The Sri Lanka authorities should be commended for intensified efforts in decidedly difficult circumstances. Though delayed, steps have been taken to reform and privatize public enterprises and to eliminate subsidies. Adjustment of the exchange rate in late 1989 was timely and it appears to have improved trade performance. Increases in the prices of publicly supplied goods and services have also been steps in the right direction. In the process, growth has picked up, and gross official reserves have grown faster than anticipated.

However, notwithstanding these developments, the Sri Lanka economy is certainly not out of the woods, and the problem of poverty alleviation remains to be addressed. The external environment has recently weakened significantly, adversely affecting the medium-term outlook. Inflation remains uncomfortably high, with the potential for derailing the hitherto fragile recovery. Moreover, security issues continue to be of concern. Despite progress, the pace of structural reforms remain slow, the process of privatization tentative, and the need for resource mobilization large in order to effect a steady and self-sustaining turnaround.

...

Under the circumstances, controlling inflation and restoring external viability should be the primary objectives of the adjustment effort in 1990-91, so that sustainable growth could take place over the medium term. While I agree with the staff appraisal and the broad thrust of policy recommendations, the program may have to be strengthened to address the recent internal and external developments. A number of issues need to be emphasized.

The program very appropriately attaches the highest priority to a substantial reduction in the budget deficit relative to GDP. However, it is not clear whether such an objective is feasible without a further strengthening of the fiscal program and whether the lower level of real government expenditures projected for 1991 will be consistent with the growth target. With public investment remaining unchanged at 9 percent of GDP and the external impetus to growth weakening, realization of the growth objective may require a dramatic increase in private investment, which does not seem to be in the offing.

The objective of limiting the growth of nominal current expenditures to 3 percent in 1991 is commendable. However, for a number of well-known reasons and in an environment of high inflation, it may be difficult to achieve the implied real expenditure decline. This possibility is particularly relevant because the budget estimates for 1991 seem to be based on assumptions that may not be fully reflective of the present circumstances. Clearly, the viability of such expenditure restraint would crucially depend upon whether additional steps could be undertaken.

It seems to me that the authorities may have to either curtail their growth objective or consider a more accelerated implementation of reinforced tax reforms. A further quickening of substantive cuts in government employment and restraint on security expenditures may be difficult. Alternatively, there may have to be a larger inflow of concessional assistance, which is already projected to be larger than in 1990. I would like to hear the staff's reactions to this possible scenario.

I note the authorities' decision to raise domestic prices of oil products in view of higher world oil prices. While noting the staff's recommendation for further upward adjustment in these prices, I would like to emphasize strongly that the staff and the authorities should be prepared to seek downward adjustments in these prices when the world oil prices start returning to more normal, nonspeculative levels. Such a step would be essential to ensure allocative efficiency.

Concerning the external sector, a stronger fiscal effort, combined with a tight monetary policy, would be needed to achieve the stated external reserves objective. I also endorse the authorities' desire to avoid large exchange rate actions which would intensify inflationary pressures. While it is possible that the resurgence of inflation may have weakened competitiveness, it would be self-defeating to deal with this problem by instituting a creeping devaluation of the rupee. Instead, tighter fiscal and monetary policies, combined with wage restraints, should be the primary means for ensuring the stability of the exchange rate. On the face of it, the newly instituted exchange system, under which the Central Bank determines the daily reference exchange rate based on market forces, seems appropriate. However, its success in ensuring competitiveness, stability, and confidence will depend crucially upon the effectiveness of policies to contain inflation.

Being a small and a relatively open economy, Sri Lanka could benefit from the exchange rate acting as a nominal anchor. Thus, the burden of adjustment in the real exchange rate should, in part, be borne by changes in the domestic price level brought about through restrictive financial policies instead of frequent adjustments in the nominal rate. I would appreciate staff reactions to these observations and also a brief evaluation of experience so far with the new system.

An important element in the planned structural transformation is the promotion of foreign investment. The program for 1991 assumes a 35 percent increase in such investment. Could the staff provide information on the specific steps taken so far that would reverse the past trend so dramatically? Also, is it feasible to accelerate the process of trade liberalization that could also benefit direct foreign investment? In this context, it is necessary that trading partners should permit freer access to Sri Lanka manufactured products.

Another important area calling for an early and decisive response is the privatization or autonomization of the large public sector. It is to be hoped that the authorities are able to adhere to the structural benchmarks for 1990-91 relating to public administration reforms and privatization of state enterprises. In particular, the financial sector reforms need to be accelerated. Could the staff also identify factors discouraging an outright privatization of the state enterprises in the manufacturing sector? Would not a speedy privatization of such activities encourage domestic savings, as well as domestic and foreign investment? Finally, could the staff review progress that has been made toward reducing the maximum tariff rate and its implications for domestic protection and revenues?

Given its track record and the need for continued structural reforms in order to restore medium-term external viability, Sri Lanka would benefit from access to the enhanced structural adjustment facility. With these remarks I support the approval of the proposed decisions.

Mr. Menda made the following statement:

Reflecting back on the last Board meeting on Sri Lanka, one can measure the major turnaround in the economic situation which resulted from the strict implementation of the program. The authorities have thereby demonstrated their ability to implement sound policies. Their prompt reaction to the recent events in the Middle East, including the full pass-through of oil price increases, is also reassuring. A major adjustment in the fiscal accounts and the implementation of structural measures have improved the economy's performance in terms of growth and external position. However, the situation remains fragile, and one can point to two major sources of concern: first, the resurgence of inflation--the rate reached 24 percent in July and could jeopardize the pursuit of the adjustment process--and, second, the fragility of the external position in the context of the Middle East crisis. Furthermore, one cannot but be worried by the difficult social and political circumstances which prevail again in Sri Lanka. In this context, it is clear there is no room for complacency and the authorities should adhere strictly to program targets. I generally agree with the staff report and will only make the following comments.

First, I am encouraged by the strong reduction in the fiscal deficit beyond the program's 1989 objective. Its unsustainable level, close to 16 percent of GDP, had made the adjustment overdue. The reduction in current expenditures--in particular, the elimination of subsidies in many areas--is most welcome. However, I feel less confident for the future, because the pace of adjustment envisaged in the program is due to slacken somewhat.

On the revenue side, I share the staff's concern that the tax reform could bring a loss in revenues. Could the staff be more explicit on the reasons why a reform aimed at "simplifying the existing tax structure, broadening the base, increasing the elasticity of the system, and improving tax compliance" should result in such a loss. I would therefore recommend a close monitoring of the reform and moving ahead with the implementation of the value-added tax.

On the expenditure side, I welcome the progress made so far. I found particularly encouraging the efforts to restructure the costly Jana Saviya plan and to target the Government's principal social programs to the poorest groups. On the other hand, I am concerned about the rise in defense expenditure from 3.5 percent to 5 percent of GDP, which will weigh heavily on the budget, and I believe there is room left for cutting current expenditure, given the substantial size of the public sector in the economy.

Second, the rise in the rate of inflation should be preoccupying the authorities. This increase originated with three factors: the adjustment of relative prices following the elimination of subsidies, the impact of the devaluation of the rupee, and the relaxation of monetary policy at the beginning of this year, which came at an inopportune time. Could the staff give us some particulars on the respective contribution of these three factors to inflation? In my view, monetary policy should be tightened and the authorities should aim at achieving positive real interest rates rapidly. There appears to be ample scope to develop indirect instruments of monetary control, and phase out refinancing at preferential interest rates.

A tightening of monetary policy, would help to diminish the rate of inflation and would allow the authorities to maintain a stable exchange rate. At the same time, it would attract capital and replenish international reserves. I agree with the remarks of Mr. Iqbal and Mr. Wright on this issue. I have, indeed, some difficulties with the staff's recommendations on the exchange rate policy. I interpret them as a strong incentive to shift to a floating exchange rate system and to make use of further depreciation of the rupee in order to maintain the economy's competitiveness. The staff, however, recognizes that the current stability of the rupee, as well as its earlier devaluation, and the sound financial policies put in place by the authorities, have restored business confidence. Indeed, the policy of depreciation of the rupee is nothing new. Looking at Chart 4, page 22, this policy has been practiced for many years, with little success at times. Furthermore, the external position has been strong since the beginning of the year, with a surplus of SDR 93 million that has allowed Sri Lanka to pay off all short-term borrowings by the Central Bank, as well as to raise its reserves by SL Rs 36 million. I doubt that a depreciation of the currency can do anything to reduce the prospective increase in defense-related imports. I have no doubts with respect to the impact a further depreciation would have on business confidence, on capital flows, and on the level of inflation.

Lastly, turning to structural reforms, I fully agree with the importance placed on a rapid and substantive reform of the public sector, given its dominant role in the economy. We commend the authorities for reducing the structure of government and for implementing a policy aimed at restructuring and privatizing public enterprises. These policies are certainly encouraging. I believe, however, that these reforms should be speeded up in view of the benefits that can be reaped. I have the feeling that in certain sectors, such as tea and rubber, which are largely dominated by state enterprises, progress has been rather slow. Another essential area is the reform of the financial sector, which is crucial to a better allocation of resources and a more efficient conduct of monetary policy. In these respects, the policy framework paper appears to fall short of our expectations. Could the staff or Mr. Fernando give us some details on this issue?

Mr. Fogelholm made the following statement:

As in most oil importing countries, the Middle East crisis has brought new clouds to Colombo's otherwise brightening economic horizon, thereby again threatening economic stability and the already vulnerable external position. Nevertheless, I believe that it is fair to say that the economic prospects are now more favorable than they were a year ago. This outcome is, of course, due to the remarkable economic recovery which took place under the second annual arrangement of the SAF. The economic advances clearly demonstrate the benefits that accrue from the pursuit of appropriate policies and from the return to relative peace in the country. The economy's positive response has been most encouraging and should be a confidence booster for the authorities; it should also support them in their efforts to restructure the economy and to seek actively a peaceful solution to the security problems.

I am pleased to note that the authorities are in full accord with the staff's analysis as regards future policies: continuing macroeconomic stabilization, streamlining the public sector, improving the climate for trade and industry, and strengthening the financial sector. Consequently, we can, and indeed, should expect that the Sri Lanka authorities will firmly implement the third year structural adjustment arrangement and avoid slippages that could, in the current difficult external environment, push the program off track.

I support the view that the fight against inflation should--in the present situation--be given first priority. If inflation could be drastically curbed, the deterioration in competitiveness would be halted, thereby facilitating a continuation of the maintenance of a stable exchange rate--and here, I share the views expressed by other Directors on this point. Furthermore, a drop in inflation would be one of the best ways to enhance protection of the poor and simultaneously make the adjustment of the country's welfare program much easier. In this connection, I welcome the Government's efforts to retarget these programs to the truly needy and to help them become more productive and employment-oriented.

Even though the reasons for the continuing high inflation rate are not fully clear to me, it is obvious that monetary stringency is called for, perhaps to an extent beyond that which is currently envisaged, and at least to the extent that positive interest rates would result soon. In addition--and Mr. Fernando makes that point--financial sector reform seems to be urgently required in order to increase the efficiency of monetary policy.

The public sector is another area where further significant progress is needed. The Government should have perhaps been even more ambitious in its efforts to reduce the budget deficit, thus leaving more room for the private sector. Like other Directors, I believe that both sides of the budget should be tackled. In order to do away with bureaucratic impediments to business activity and thereby promote both domestic and foreign investment, the Government, as noted in the staff report, has actively sought to diminish remaining regulations. However, I would like to inquire of the staff, or Mr. Fernando, whether they consider that the authorities have gone far enough, or whether red tape still hampers investment.

Finally, I share the views of the Sri Lanka authorities that progress to date, both in the macroeconomic field and in the area of structural reform, together with--what I believe can be expected--satisfactory implementation of the third year structural adjustment arrangement, would provide a good foundation for a future ESAF program. With these remarks, I can approve the proposed decisions.

The Deputy Director of the Asian Department said that the staff had revised macroeconomic projections to take into account the impact of events in the Middle East on Sri Lanka's economy. The revised projections, presented in the staff paper, were based on the world economic outlook oil price assumptions, as well as on an assumed 30 percent reduction in remittances. The projections also reflected the policy adjustments that had been implemented, including the full pass-through of higher oil prices to domestic prices and the tightening of fiscal policy. The overall impact of the revisions on the current account deficit was expected to be an increase of about half a percentage point of GDP for 1990 and close to one percentage point for 1991. At the same time, the target on gross official reserves was adjusted downwards from the levels previously discussed with the authorities.

With respect to the domestic economy, the Deputy Director noted that the GDP growth target had been reduced slightly--by less than half a percentage point--to 4.8 percent for 1990 and 4.5 percent for 1991. However, no change had been made to price targets, because of the policy adjustments taking place simultaneously, as well as the estimated slower growth in GDP.

As to the causes of the rapid inflation over the past several months, the Deputy Director said that the authorities and the staff underestimated the impact of subsidy elimination. Structural rigidities--causing slow supply responses--were also responsible. In addition, the sharp wage increases that had taken place just before the second-year program started--the decision having been made in the fall of 1988 and implemented during the course of 1989--had fed into the inflation process. During the current program period, no decision leading to higher wages had been taken, except for a minor adjustment for relatively low-paid government employees.

As for the adequacy of the inflation target for 1990 and 1991, the Deputy Director said that the trade-off between the inflation and growth targets had to be considered. The authorities and staff both were of the view that the recovery needed to be protected, because domestic economic and social stability hinged crucially on the continuation of economic growth. When the program had been formulated, the annualized inflation rate was 24 percent, and reducing the inflation rate to 16 percent appeared to be a major challenge. However, the staff believed that, in light of subsequent developments, the target was both appropriate and achievable. The 10 percent program target for 1991 could be reviewed with the authorities later and could possibly be made more ambitious, given the recent encouraging signs that inflation had peaked and if the 1990 target of reducing inflation to 16 percent could be achieved.

With respect to tax reform, he observed that the Government was studying the structure of its finance in the long run--that is, what would be the adequate levels of expenditure, revenue, and taxation, and what would be the adequate size of government itself. The view was that the current revenue/GDP ratio of 20 percent was probably appropriate, as that ratio was one of the higher ones in the region. However, the ratio of expenditure to GDP, which exceeded 30 percent and was also one of the highest in the region, should be reduced, in order to reduce the overall budgetary deficit in the short run. It was also consistent with the Government's long-term objective of reducing its involvement in economic activities and raising that of the private sector. Based on that view, the focus of tax reform was not so much to come up with measures to raise the tax/GDP ratio but to rationalize the existing system. In that context, the tax commission had been reviewing various tax items--for example, import duties, which were not only high, but also complicated. As part of trade reform, lowering and simplifying some of the high duty rates were considered important, although some revenue loss in the short run would result. At the same time, the Government was considering adjusting domestic excise taxes and improving tax administration--in particular income taxes.

As to government expenditure planned for 1991 and its consistency with the growth target, the Deputy Director noted that the emphasis would be to slow current expenditure, while maintaining the momentum of capital expenditure--in contrast to 1989 when current expenditure had increased and capital expenditure had been cut; or 1990 when that trend had continued to a large extent. The growth target could be attained, given that shift in the composition of government expenditure and the expected increase in private investment.

The exchange rate was currently moving in the right direction, but the Central Bank had experienced some difficulties with the new exchange rate system when it was introduced in late August 1990, the Deputy Director explained. At that time, three factors had led to strong pressures on Central Bank reserves. First, after a period of relatively high inflation, there were strong expectations for a major devaluation. Second, the introduction of the new system strengthened expectations--it was taken by market participants as a sign that the devaluation was imminent. Third, the announcement of the new system unfortunately had coincided with events in the Middle East; the expected impact of that crisis on the balance of payments of Sri Lanka had also put pressure on Central Bank reserves. The Central Bank had dealt with those pressures on reserves by intervening at an early stage and at a rate close to the reference rate. In other words, the Central Bank had protected the rate at the cost of reserve losses. That situation had continued for about ten days, but the market had eventually stabilized. Subsequently, the Central Bank had regained and even increased reserves.

Another challenge had come more recently, when the Central Bank had decided to reduce its interventions and let the market play a greater role in determining the exchange rate, the Deputy Director said. Again, that move by the Central Bank was taken as a sign that the rate might be devalued, and there was some pressure on reserves. However, the pressure was much less, and after two or three days the situation had calmed, and the Central Bank resumed purchases of foreign exchange in the market.

With the exception of those difficulties, the experience on the whole had been successful, the Deputy Director commented. The market conditions had necessitated a considerable number of interventions by the Central Bank. The exchange rate reflected transactions between the Central Bank and commercial banks. Some elements of the market had become factors in the determination of the exchange rate, and the role of the market was growing.

The reform of some sectors was progressing well, the Deputy Director of the Asian Department observed. But in certain other sectors--particularly the tea sector--progress was slow, perhaps because in Sri Lanka the tea sector played a key role and had a large number of employees. Nevertheless, the authorities were working together with the World Bank and other institutions, and the hope was that progress over the next few years could be accelerated.

Mr. Fogelholm asked the staff to elaborate on its view of the exchange rate, particularly with respect to one Director's observation that the staff report could be interpreted as endorsing a more flexible exchange rate.

The Deputy Director of the Asian Department remarked that the staff's views were twofold. First, establishing the market's role was currently very important and was in line with the authorities' overall objective of reducing government intervention and increasing the market's role in the system. Second, the authorities should be prepared to adjust the rate if needed. In making that decision and conducting market interventions, the authorities would have to be guided by two principles: the maintenance of its reserves at an adequate level and achievement of the reserve target; and the maintenance of competitiveness of exports.

As to the issue of competitiveness, the Deputy Director of the Asian Department said that the almost 12-month period of inflation resulted in a real effective appreciation of the rupee, although currently there were no clear signs that export competitiveness had been lost. He also said, given the reserve targets, the Central Bank would have to buy foreign exchange from the market in the next several months, which might mean that it would have to offer a better rate in the market; in other words, the rate might depreciate. In light of that effective appreciation, some depreciation of the exchange rate might be considered necessary. However, so many other factors--as explained in the staff paper--would affect the determination of the rate that the authorities would have to address them in a flexible manner and, at the same time, they would have to remain prepared to adjust the rate.

Mr. Goos made the following statement:

> I welcome the substantial adjustment efforts of the Sri Lanka authorities under the second structural adjustment arrangement. These efforts, and the pronounced favorable response of the economy, are indeed quite encouraging against the background of not only the unsatisfactory experience under the previous arrangement, but also the challenges arising from the Middle East crisis.
>
> But there is little doubt that much remains to be done--perhaps more than one would normally have expected after so many years of Fund involvement--both in the area of structural reform as highlighted in the report in the chapter on "the structural origins of financial imbalances," and with respect to financial stabilization. In this latter regard, it is striking that, at some 10 percent of GDP, the fiscal deficit for this year and the next would constitute virtually no progress against the deficit, which stood at a higher level than it had in 1984; moreover, the deficit projections for this year and the next would imply a continuation of the worrisome trend of public sector dissavings that emerged in 1988.
>
> Further vigorous fiscal consolidation would therefore appear crucial for achieving sustainable growth generated by the private sector and is also of paramount importance with respect to the immediate concern of bringing down inflation. That task is being

complicated by a number of factors, as is rightly stressed in the report, above all by the renewed and most unfortunate outbreak of civil war and its heavy human toll, its adverse impact on confidence, and its drain on fiscal resources--5 percent of GDP. It therefore appears that restoration of domestic peace should be pursued with the highest priority.

Having said this, I am concerned that the task of reducing inflation and, more generally, of financial stabilization might also be rendered more difficult by the new exchange rate regime--especially if the Central Bank followed the staff's advice "to move the rate flexibly and speedily whenever necessary to achieve its [foreign reserve] objectives" and maintain export competitiveness.

I certainly recognize that the previous peg of the rupee to the dollar was probably not sustainable, as is made quite obvious by the rapid erosion in external competitiveness immediately after the recent devaluation, as shown in Chart 4. However, it appears that the devaluation itself has to be blamed in large measure for the acceleration of inflation underlying that erosion. I wonder whether this loss of competitiveness in turn cannot be traced to some systemic factors, such as limited domestic competition and the predominance of primary products in Sri Lanka's exports. At any rate, Chart 4 seems to suggest that, in the circumstances of Sri Lanka, an active exchange rate policy as recommended by the staff is a highly questionable instrument for effecting external competitiveness in any lasting manner. Actually, only one year or so after the devaluation of the rupee, Sri Lanka seems to be worse off than before, in terms of its export competitors.

This aside, I feel that the lack of transparency and of specific market guidance associated with the managed float is particularly unfortunate at the present juncture of widespread uncertainties on the domestic and external fronts. Those uncertainties could easily give rise to speculative pressures, which, combined with the rule for the setting of the Central Bank's reference rate, would threaten to produce a devaluation/inflation bias.

Against this background, I would urge the authorities to adopt a more transparent and binding exchange rate regime. At any rate, the concerns related to exchange rate policy serve to reinforce the staff's advice to pursue restrictive monetary and fiscal policies. They also reinforce the need to increase interest rates to a level that not only is positive in real terms, but also provides a sufficient risk premium to compensate for the increased uncertainties about the future direction of exchange rate developments. Moreover, I feel that it would be highly advisable not to treat the quite ambitious growth projections for next year as an explicit policy target. Rather, the authorities should assign priority to a reduction in inflation, further fiscal consolidation, and the achievement of external viability. Acknowledgment of these priorities in turn clearly points to the need for continued vigorous efforts at structural reform along the lines recommended by the staff--notably, reform of the financial system and the public enterprise sector.

With these observations, I endorse the staff appraisal and support the proposed decisions.

Continuing his remarks, Mr. Goos said that he had difficulties with the explanation of the Deputy Director of the Asian Department that the move to the new exchange rate regime reflected the authorities' determination to introduce generally an element of market orientation into their economic policies. There was no contradiction between a stable exchange rate arrangement, including a peg, and market orientation of economic policies in general. There had been many examples. He shared the concerns expressed by previous speakers that the new exchange rate arrangements might complicate the tasks of stabilization and restoring sustainable growth.

The Deputy Director of the Asian Department replied that the staff recognized the need for greater transparency and, perhaps, a more binding formulation for the exchange market intervention. But, at the same time, it noted that the current system represented only an initial step toward more market-oriented arrangements. In that context, it was important that the authorities moved slowly, step by step, to gain experience in the required skills. Eventually, greater transparency and sophistication in market arrangements would emerge.

As for the budget deficit target, he agreed that the public sector deficit target for 1991 was about the same as it had been in the mid-1980s, the Deputy Director of the Asian Department remarked. However, between 1984 and 1990, Sri Lanka had had a major domestic financial crisis, with the deficit rising to over 15 percent of GDP in 1988. As part of their current efforts to stabilize the economy, the authorities were trying to reduce that deficit to its 1984 level. If they succeeded, they would follow up with a still lower deficit target.

Mr. Goos responded that he recognized that Sri Lanka had experienced a major financial crisis in 1984-90, which might even reinforce his point. One would have to know the causes of that financial crisis. Perhaps the large 1984 deficit, about 10 percent of GDP, had caused that crisis.

His reference to transparent and binding rules for exchange rate policy did not mean that he had in mind that the exchange rate should be market determined, Mr. Goos remarked. A free-floating exchange rate would be inappropriate in the circumstances of Sri Lanka.

Mr. Kpetigo said that the bold economic reforms launched by the Sri Lanka authorities were bearing fruit. The staff report, which he generally endorsed, clearly indicated that a broad-based recovery was taking place and external viability was being restored, despite difficult internal and external conditions. Nevertheless, the economy of Sri Lanka was still fragile, and the momentum needed to be maintained as the reform program continued. In that connection, he welcomed the prompt measures taken in response to recent adverse external developments.

Under the second arrangement, the financial accounts had improved markedly, after a number of setbacks during the first arrangement owing chiefly to the unsettled conditions that had prevailed before the inception of the program, Mr. Kpetigo observed. In general, macroeconomic performance had exceeded expectations, as better security conditions had helped stabilize the socioeconomic environment and facilitated tight fiscal and monetary policies.

With respect to financial policies, the strong measures planned under the third annual arrangement to reduce the fiscal deficit and inflation were welcome, Mr. Kpetigo said. However, while expenditure should be further reduced, an appropriate investment budget should be maintained in order not to jeopardize the momentum for growth. Similarly, the planned reduction in public sector credit for 1991 was welcome. However, he wondered whether the quarterly credit ceilings set for December 1990 and June 1991 were still valid, given the effects of the Middle East crisis on Sri Lanka's economy.

In the external sector, the significant strengthening of the balance of payments in the first half of 1990 was welcome, Mr. Kpetigo said. However, the prospective sharp increase in security-related imports and the huge debt-service payments scheduled for the second half of the year, together with developments in the oil market and the projected shortfall in foreign remittances, all pointed to the need to exercise extra caution in the management of international reserves in the months to follow. In that connection, the staff's latest projections of the impact on the external accounts of those developments would be appreciated.

On structural issues, important progress had been made in the implementation of industrial policy and the reform of public enterprises, Mr. Kpetigo noted. The authorities had continued their efforts to enlarge the role of the private sector. The industrialization strategy announced in December 1989--aimed at reducing the regulation of business activities and promoting investment--had been a step in the right direction. The authorities' continued commitment to streamline the public sector was encouraging. In undertaking such efforts, the authorities had been right to maintain a social safety net to protect the poorest and most vulnerable groups of society, especially as the elimination of various subsidies had resulted in sharp price increases for certain basic commodities. In that context, he shared Mr. Fernando's views that, although the Government of Sri Lanka bore primary responsibility for the reduction of poverty, its efforts should be complemented by industrial country policies and by strong donor and creditor support. He supported the proposed decisions.

Mr. Hogeweg said that he shared the concern expressed by some speakers on the exchange rate policy. The Deputy Director of the Asian Department had emphasized that any move the authorities made on exchange rate policy was taken by the market as a sign that the exchange rate was likely to depreciate. Given his subsequent response on the authorities' policies and the need for flexibility, the market's anticipation of a depreciation was to be expected, because the market also recognized that reserves needed to be maintained, and even increased; and competitiveness, after the relatively high inflation, was a cause for concern. However, any market orientation of exchange rate policy only reinforced the necessity of a tight domestic financial policy. The tendency for the market to interpret anything that happened as a sign of a depreciation might well imply that the market might not have much confidence in the ability of the authorities to follow through on a tight domestic financial policy.

Mr. Wright remarked that he agreed with Mr. Hogeweg's comments on the exchange rate policy. The nominal exchange rate had depreciated almost continuously since 1985 and that trend was likely to continue. He asked the Deputy Director for clarification on issues arising out of Chart 4 on page 38A, to which others had also referred. The real exchange rate--as shown by the line for manufacturing exports--had fallen in the sense that competitiveness in the manufacturing sector had actually improved between 1986 and 1989, before the 20 percent devaluation of 1989. Over the same period, the nominal exchange rate had depreciated by about 12 percent, which suggested--notwithstanding all the many difficulties that the Sri Lanka authorities had faced--that there had been some underlying improvement in competitiveness in terms of relative costs in the manufacturing sector. Some diversification in that sector--away from primary products--had been hoped for. Therefore, a long-term improvement in competitiveness appeared to have taken place.

He wondered to what extent the improvement in trade in 1989, which had been concentrated almost entirely in the manufacturing sector--as was made clear in Table 17, page 31 of the background paper--had been a lagged response to that gradual improvement rather than a response to the 1989 depreciation--a response not normally seen, Mr. Wright remarked. Following up on Mr. Goos's point, he asked the Deputy Director why, when competitiveness had been improving over quite a long period, the gains in competitiveness were suddenly reversed in mid-1989, when a depreciation was introduced--as shown very clearly in Chart 4 on page 38a of the background paper. Mr. Goos had pointed out that the level of competitiveness after the depreciation was worse than before. It was tempting to speculate that competitiveness had gradually improved and the authorities had then reacted inappropriately by depreciating the exchange rate and easing up on other policies. That easing up had rebounded very seriously on the authorities--a good argument for not depreciating any further.

The Deputy Director of the Asian Department replied that a large part of the movement of real effective exchange rate indices--particularly for manufacturing exports during the period 1985-89--reflected those of Sri Lanka's competitors, namely, the newly industrialized countries. The effective depreciation at that time had come largely from the strengthening of competitors' currencies. However, the bottom line effect was that the Sri Lanka manufacturing sector had somewhat improved its competitiveness during those years.

The recovery of exports in 1989 most likely reflected that strengthening of competitiveness, the Deputy Director of the Asian Department said. The restoration of security was also a major factor. In previous years, manufacturing firms had experienced work stoppages, difficulty in delivering goods from factories to ports, and other disruptions. Also, greater confidence--not only in the security situation, but also in government policies--had led to a pickup in economic activity, including exports.

Mr. Wright noted that currency movements could, over several years, have led to the improvement in competitiveness to which he had referred. The proportionate improvement in real competitiveness was larger than the nominal depreciation--although the two were highly imperfect and perhaps not strictly comparable. In that event, there must have been an improvement in relative costs. During that period, the real exchange rate had been reduced about 20 percent and the nominal exchange rate about 12 percent; the difference could be accounted for at face value by an improvement in relative costs. Therefore, on that basis, the nominal depreciation might not have been appropriate at all. It was his view that the improvement in competitiveness had been greater than could be ascribed to movements in relative exchange rates alone.

The Deputy Director of the Asian Department noted that the statistics used to produce the charts were not sophisticated. Even the index for manufacturing exports--taking into account the relative movements in costs--was simply the ratio of two elements: the relative nominal exchange rate movements and relative price movements. He agreed that other factors were involved in addition to the relative nominal exchange rate. Inflation had increased substantially in the past 12 months and had contributed to the effective appreciation of the currency.

The Acting Chairman suggested that it therefore was the higher inflation in competitor markets that accounted for the behavior of the real exchange rate.

Mr. Wright remarked that, on that basis, one could actually ask whether the nominal depreciation experienced from 1985 onward had been necessary to secure an improvement in competitiveness, although the improvement in competitiveness would have been smaller in the event of a fixed nominal exchange rate. The answer to that question had an important bearing on the interpretation of the 1989 depreciation, the policy prescription for 1991, and the appropriateness of a further depreciation.

The Acting Chairman observed that the issue was complicated. One view was that a step devaluation was better than a gradual nominal devaluation. Although care needed to be taken in interpreting the charts, following the large devaluation of late 1989, the dollar-rupee rate had been relatively stable. The question then devolved on the meaning of an exchange rate anchor and whether holding the dollar-rupee rate could help bring Sri Lanka's inflation rate down toward the U.S. rate. If so, the situation was changed from the past, when there had been a gradual nominal devaluation against the dollar and a much larger nominal effective devaluation compared with other currencies, partly because of the very sharp decline in the dollar since 1985. However, Sri Lanka had done very well over a period of time in improving its competitiveness with a nominal exchange rate that had adjusted gradually. The question was whether the authorities had encountered difficulties with a sudden step devaluation followed by a relatively constant exchange rate.

He wondered what was the key exchange relationship the Sri Lankan authorities were focusing on, given the nature and size of capital flows, the Acting Chairman continued. Was it on the U.S. dollar-rupee rate, the Japanese yen-rupee rate, or the Indian rupee-rupee rate? One should not ignore either the importance of tourism earnings. The question was really whether the general public paid more attention to one or the other of the nominal rates or to the real effective exchange rate.

The Deputy Director of the Asian Department remarked that the Sri Lanka authorities had looked at the U.S. dollar-rupee rate very carefully. Experience since September of 1989 had led to two broad observations. One was that the policy of sharp depreciation, followed by a period of a stable exchange rate vis-à-vis the dollar, had worked very well. As reported in the staff paper, the impact on the balance of payments--both current and capital account transactions--was positive. The policy had also restored business confidence. On the other hand, the authorities recognized that, given the relatively high rate of inflation in Sri Lanka, the exchange rate might have to be adjusted in the future. In order to maintain a fixed rate in the short term, a larger amount of reserves than Sri Lanka currently held might be needed to deal with any speculation that might occur; for that and other reasons, the authorities wanted--and needed--to be prepared to adjust the rate.

Mr. Moss made the following statement:

Let me start off by concurring with previous speakers that the Sri Lanka economy witnessed an impressive turnaround in 1989, albeit with one major disappointing feature, inflation, which accelerated despite tight financial policies. Nevertheless, like others, I would like to caution against too optimistic a mood. One should, indeed, not lose sight of the fact that Sri Lanka is bound to be hard hit by the Middle East crisis, even if the most recent information contained in the supplement to the staff report does not yet bear evidence thereof. I would like to recall here that the World Bank staff has estimated the change in Sri Lanka's external accounts for 1991 and 1992, owing to non-oil factors, to be the fourth largest in terms of GDP--that is to say, the worst result when one excludes the three front-line states. Let me hasten to say that I do not intend to cast doubt on the overall validity of the staff's analysis. On the contrary, its thorough analysis of Sri Lanka's economy and the particular attention paid in the annexes of the background paper to such critical issues as inflation, the fiscal deficit, and export development, have helped me to focus my remarks, to which I will now turn.

First, a general observation: the authorities need to ensure that their third annual structural adjustment arrangement, although commendable overall, does not turn out to be like the first one--marred by slow economic growth, rising inflation, and a weakening balance of payments. After all, the successes of the second annual arrangement in 1989 were at least in part due to the fact that the base for comparison was a very mediocre one. Annex III of the background paper speaks in terms of a rebound from the politically unstable year of 1988. Moreover, inflation continued to rise and the favorable budgetary outcome for 1989 was, to some extent, the result of onetime revenue effects. The upcoming year does not offer the same favorable prospects. I have already mentioned the effects of the Middle East crisis. There is also the question of renewed civil unrest, which already in 1990 resulted in supplementary budgetary expenditure appropriations. One could equally wonder whether the policy of cutting back on government capital expenditure has not reached its limits with the 9 percent of GDP figure projected for 1990--at least if the Government seriously intends to play a role in creating a favorable business climate.

To round off my warnings on the economic outlook for Sri Lanka, I would like to point out that the output response to the structural adjustment over the 1987-89 period has been sluggish, with real GDP growth barely averaging 2 percent, but, more importantly, with gross fixed investment growing at a negative rate over the whole 1986-1990 period--a very weak base, indeed, for a sound real GDP growth rate of 4.5 percent, as projected for 1991. If such a growth rate were to be achieved, the probability of further increases in internal and external disequilibria cannot be ruled out. Are the projections of a lower current account deficit--7 percent of GDP compared with 8 percent in 1990--and of significantly lower inflation--10 percent compared with 16.5 percent in 1990--not too optimistic in this light?

The projections on inflation especially seem too good to be true. Indeed, I can see at least three reasons for questioning the staff's projections in this respect. First, a number of price increases have just been carried through, such as the ones on petroleum products and the bus and train fares. The policy framework paper also mentions the Government's intention to completely deregulate the prices of essential commodities, as well as cut railway subsidies for 1991. Second, as pointed out in Annex I of the background paper, a great deal of inertia exists in Sri Lanka's inflation rate, pointing at deeply entrenched inflationary expectations which are not going to dissipate overnight in 1991. Third, the staff paper speaks of liquidity growth in 1991 being limited to 14 percent, supposedly significantly below nominal GDP growth. The qualification 'significantly' seems to imply that the projected inflation rate must be well above 10 percent, because real GDP growth expected for 1991 is already 4.5 percent.

This less bright outlook for inflation has a bearing on other internal and external policy issues. Internally, it should provide a spur to accelerate financial sector reform, a point already made by Mr. Fogelholm and others. Moreover, sufficiently tight financial policies will henceforth have to rely on a more stringent budgetary policy that has among its objectives a reduced and more efficient public sector labor force--an objective which should be pursued more forcefully. In this respect, I would like to hear the staff's comments on the following issues. Will the initial target for 1990--a reduction of 18,000 to 20,000 public sector jobs--be reached, and is there already a timetable for further reductions over the next three to four years? Is the recruitment for the armed forces, which was responsible for the sharp increase in central government employment in 1989, likely to be reversed when the civil unrest subsides? Is the decentralization to the provincial level of certain government jobs not going to complicate labor mobility in the public sector and, therefore, hamper the drive toward a more efficient government?

Turning to the external policy link of higher than projected inflation, I have doubts, as have Mr. Menda, Mr. Goos and other European chairs, as to whether the newly introduced exchange system, which--according to the staff--should operate with sufficiently wide bands, is not going to further complicate the task of reining in inflationary expectations. Indeed, with insufficiently tight financial policies, this system risks triggering a substantial devaluation, which will, in turn, aggravate the problem of imported inflation, already in the past a weighty factor in determining Sri Lanka's inflation rate, as Annex I of the background paper explains. Moreover, when looking at the evolution of the real effective exchange rate since the third quarter of 1989, the short-term gains of the devaluation have evaporated, a point already discussed amply by previous speakers.

Leaving the short-term for the medium-term analysis, I concur with the staff's view that little margin for error exists in the 1990-95 scenario, as reflected in Table 8 of the staff report. To clarify matters further--which is especially important in order to assess in detail the extent of the financing gaps to be filled over the medium-term--I would like to hear the staff's comments on the following issues. Is the staff's projection of foreign direct investment actually all that cautious, because, from 1990 onward it entails a sharp reversal of the decline in foreign direct investment--a point already touched upon by Mr. Iqbal? Could the staff provide more detail on the sensitivity of its assumptions regarding oil prices and worker remittances, as touched upon in Footnote 1 on page 32 of the staff report? Perhaps the staff response could be made along the lines of the assumptions developed in EBS/90/179 concerning the Fund's response in the wake of recent developments in the Middle East.

Finally, I would like to reiterate my initial remarks that I do not intend to throw into doubt the overall validity of the staff's analysis. I therefore support the proposed decisions. At the same time, I would like to wish the Sri Lanka authorities well with the restructuring of their economy, and I hope that the better than expected response of 1988 will not prove shortlived.

Ms. Powell said that she was in broad agreement with previous speakers and welcomed the generally commendable performance of the past year. The need to reduce inflation, maintain tight financial policies, and move ahead with structural reform was urgent. On exchange rate policy, any advantages of a pegged rate as a nominal anchor had to be weighed against a more flexible market-oriented policy in maintaining external competitiveness. In either event, tight financial policies and other sound domestic actions, including reforms, were needed. The resilience of Sri Lanka's economy over the past year underscored what could be accomplished if security conditions improved and if the authorities pursued sound policies. She supported the proposed decisions.

Mr. Bindley-Taylor remarked that, as he was in broad agreement with the analysis of the staff and some of the sentiments expressed by previous speakers, he would concentrate on a few salient points. The policy thrust in the third year of Sri Lanka's arrangement under the SAF should be the preservation of the gains registered in financial management and internal security during 1989 and a sustained effort to pursue structural reforms, combat inflation and preserve external viability in the period 1990-91.

With respect to financial policies, the authorities' sustained efforts had resulted in a progressive reduction in the overall fiscal deficit from 15.6 percent of GDP in 1988 to an anticipated 10.4 percent in 1990, Mr. Bindley-Taylor observed. He agreed with the authorities that reductions in investment spending in order to reduce the deficit should be limited; however, such an investment policy implied a faster dismantling of transfers and subsidies, a faster pace of employment reduction schemes within the civil service, and the adoption of various forms of revenue enhancement. The prompt response of the authorities to the current oil crisis--namely by curbing their own fuel consumption and allowing the pass-through of price increases to the consumer--reflected their commitment to sound fiscal policies.

That the size and questionable efficiency of the public sector had been one of the constraints on the economy's ability to sustain its true growth potential during the 1980s was generally acknowledged, Mr. Bindley-Taylor commented. He welcomed the authorities' closure of some inefficient enterprises, the privatization of several others, and the more judicious targeting of transfers to all other public enterprises. He also welcomed the structural reforms intended to liberalize the trade regime, reduce the level of bureaucracy that affected domestic and foreign business activity, and promote foreign investment. The pending reforms in the financial sector were no less important.

The inability to control inflation had been the program's major setback, Mr. Bindley-Taylor noted. Although the removal of subsidies and the large devaluation in 1989 had contributed to the original inflationary impetus, the rate had not moderated, suggesting other underlying factors, some of which might be structural. Therefore, the authorities' intention to persist with their tight monetary policy, as well as to strengthen and reform the domestic financial sector, was welcome.

In response to the previous year's devaluation, the external sector had strengthened and the exchange rate was more stable, Mr. Bindley-Taylor said. Therefore even greater efforts should be made to contain inflation through strong fiscal and monetary policies, in order to avoid the destabilizing inflation/devaluation spiral that was so common in developing countries.

Sri Lanka had indicated in no uncertain terms that it was committed to the task of adjustment, Mr. Bindley-Taylor remarked. The authorities' efforts were even more commendable, because they had pursued those objectives in the midst of civil unrest. The roots of the current crisis were complex and deep-seated. Because peace would certainly improve the economic potential of the country, he hoped that the authorities and the relevant parties in the conflict would find common ground for national reconciliation in the near future. The role of the Fund in such circumstances must be to support the concerns of the authorities for economic adjustment and transformation. He therefore endorsed Sri Lanka's request for a third annual arrangement under the SAF.

Mr. Shao observed that in 1990, the economic picture for Sri Lanka had improved dramatically. During the previous discussion on Sri Lanka (EBS/89/186, 9/20/89), the substantial decrease in economic growth, the further deterioration of the balance of payments position, and the increase in the debt-service ratio had been concerns. The authorities, supported by the Fund, had made great strides in economic development. Benchmarks under the SAF program had been observed--most by large margins. The Sri Lanka authorities had determinedly pursued a strong economic restructuring program, with commendable results achieved in the face of many difficulties. As the authorities and the staff agreed on almost all analytical and policy recommendations, he would like to comment on three points of interest.

First, concerning fiscal policy, a reduction in expenditures was essential for stable economic growth and efficient allocation of financial resources, Mr. Shao commented. In that respect, as part of the second annual arrangement under the SAF, the overall deficit had been reduced at a faster pace than initially budgeted. The authorities were still taking steps to further reduce the deficit to 10.4 percent by phasing out subsidies in certain areas, restructuring the Java Saviya Program, and cutting nonwage, noninterest expenditures. That approach to policy implementation should enhance fiscal consolidation and release limited resources to private capital investment. The Government had reduced reliance on borrowing from the banking system and had repaid a large amount of the public debt--two measures that were a prelude to reducing inflationary pressures.

Second, as to monetary policy and inflation, the sharp acceleration in liquidity growth had focused attention on current inflationary pressures, Mr. Shao remarked. The staff's view that the authorities needed to implement a firm monetary policy was therefore understandable. In order to control credit expansion and absorb liquidity overhang, interest rates should be adjusted to an appropriate level. As for the problem of inflation, the authorities were fully aware that achievements made under the program could well disappear if laxity in controlling the upward trend of price developments were allowed and a worsened economic situation resulted. The attention paid by the authorities to controlling inflation had been clearly and fully expressed in Mr. Fernando's statement. However, inflationary pressures were particularly affected by other macroeconomic policy adjustments--namely, currency devaluation and subsidy removal. Those two factors made control of inflation even more complicated and necessitated further efforts at structural adjustment. It would take time to follow through on that process.

The third point involved the external sector--an area where progress had already been made, Mr. Shao recalled. The balance of payments position had improved substantially in the past 12 months. Despite positive signs in external performance, balance of payments prospects continued to need careful attention, because large debt-service payments would become due later in 1990. Adverse developments in the Middle East were also affecting

Sri Lanka's external position. To that end, he agreed with the staff that caution needed to be exercised in financial and reserve management.

Lastly, close cooperation with the Fund had helped Sri Lanka significantly in meeting benchmarks under the second annual arrangement of the SAF, Mr. Shao said. He fully supported the proposed decision; however, Sri Lanka's structural problems might take longer to sort out. The authorities should be encouraged to pursue an enhanced structural adjustment facility in their endeavors to reform Sri Lanka's economy.

Ms. Creane made the following statement:

> Events of the past year in Sri Lanka demonstrate that implementation of sound financial policies can have a quick payoff in terms of turnaround in economic performance. However, the persistence of high inflation threatens to undermine the progress that has been achieved and highlights the importance of sustaining tight monetary and fiscal policies. Moreover, the authorities will also need to accelerate structural reform efforts in order to build on the momentum that has been created over the past year.
>
> The reduction in the fiscal deficit last year, despite continuing civil disturbances, represents an impressive achievement which is the basis for the improved economic situation. However, the deficit reduction was achieved primarily through measures that are unlikely to be sustainable--in particular, sharp cutbacks in capital expenditures in the second half of the year and higher tax revenues, as inflation pushed up nominal income. In these circumstances, achievement of the fiscal objectives in the structural adjustment arrangement will require stronger efforts to curb expenditures and to improve the tax system.
>
> With renewed civil disturbances producing increased defense spending, and with capital expenditures already pared back significantly, attention will need to focus more heavily on controlling current spending if the deficit reduction objectives of the budget are to be achieved. I welcome the authorities' intention to reduce the public sector payroll through a wage freeze and increased layoffs, but I am concerned that full implementation of the layoffs would still leave public employment well above the levels of recent years. Further, the transfer of governmental functions to the Provincial Councils is creating new pressures for public spending that are difficult to contain, because the local authorities do not confront effective budgetary constraints. Unless these two areas of spending are brought under better control, the authorities' plans to shift a larger share of total expenditures to ambitious social welfare programs, especially the midday meal and Jana Saviya, will be difficult to achieve without breaking the budgetary

goals. I therefore urge the authorities to intensify their efforts to curb these expenditures.

I would agree with the authorities that tax reform should be framed in a longer-term context, but would urge that the recommendations of the Tax Commission be implemented as soon as possible. In particular, an accelerated timetable for adoption of the value-added tax would appear desirable as a means of improving the efficiency of the tax system and providing additional revenues. Such a move would seem preferable to delaying trade liberalization in order to protect the revenue base.

The increase in inflation last year was the most disappointing element of the economic picture and is surprising in light of the much tighter financial policies. In part, this increase reflected the one-time effects of subsidy removals and the exchange rate adjustment. However, it will be important to ensure--by maintaining sound monetary and fiscal policies-- that these increases do not spill over into wages and prices more generally. The staff suggests that efforts to curb price pressures in Sri Lanka may require a longer period of monetary restraint than other Asian countries because of financial market imperfections--highlighting the importance of improving the functioning of financial markets by reducing direct controls and increasing reliance on market-based monetary instruments, as well as reducing the high cost of bank intermediation.

The private sector in Sri Lanka has proven to be extremely resilient and represents a strong, growing base upon which to build future growth. The Government's efforts to reduce the size and role of the public sector is most welcome, as it will release resources that can be used more efficiently elsewhere. In particular, the privatization of several public enterprises, including the state-owned bus company, represents an important step forward. However, these actions are only a start, and I would urge the authorities to take advantage of the current momentum and growing support for privatization to accelerate the process.

The exchange rate adjustments of 1989 and stronger financial policies have produced a significant improvement in Sri Lanka's external position. I welcome the adoption of a more market-oriented exchange rate policy as a complement to sound financial policies and share the staff's view that rates should be allowed to adjust to changing market conditions. The recent performance of the economy holds out the prospect that Sri Lanka will be able to achieve a sustainable external position sooner than anticipated in the original arrangement under the SAF, although some continued external support will be required. The success of the second year of the SAF and the authorities' commitments for the third year should go far in building donor confidence, and we would anticipate a positive response at the upcoming donors' meeting.

In the final analysis, however, it will be up to Sri Lanka to sustain the current adjustment effort and to avoid the policy slippages which occurred during the first year of the structural adjustment arrangement, if the positive picture presented by the staff in the medium-term scenarios is to be achieved. Adhering to the program is especially important at the present time in light of the uncertainties created by the Middle East situation. In these circumstances, we were surprised that the current arrangement did not include a contingency and compensatory financing facility (CCFF) component to help protect the reform effort from unforeseen contingencies. We would appreciate staff comments on the reasons, including whether there are features to the facility that have discouraged the authorities from pursuing this option, and the possibility of including a contingency arrangement at this time.

Mr. Evans said that he agreed with the broad thrust of comments made by earlier speakers, with the exception of comments on the exchange rate; therefore, he would simply like to commend the Sri Lanka authorities on the significant progress they had made in the past 12 months and to comment further on one particular issue--namely, the inflation target for 1991. That the matter could be reviewed further with the authorities was welcome. However, as success in controlling inflation in 1991 would be determined largely by policies implemented currently, the authorities should review the practice of gearing policymaking to short-term objectives. Scope existed for achieving less than a 10 percent inflation rate through the course of 1991. The staff report noted that the authorities were of the opinion that the largest one-off price adjustments were behind them; if one looked at price performance in the past two months, it would appear that underlying inflation might already be running below 10 percent. Indeed, just as a matter of arithmetic, inflation would probably need to run below 10 percent from the current time until the end of 1990 to achieve the 16.5 percent figure for 1990. If the authorities were to adopt a target lower than 10 percent in the course of policy formulation--especially monetary policy--expectations of inflation would diminish.

Mr. Ahmed remarked that he supported the proposed third-year arrangement under the SAF. Clearly, a major issue facing the economic program in the period ahead was inflation. A reduction in the rate would be crucial in order to maintain the momentum of structural reform, which, in the final analysis, was the determinant of medium- and longer-term growth prospects. If the staff's analysis of the factors behind the surge in inflation in recent months was correct, then inflation should abate relatively quickly, provided that the authorities did not relax financial policies. More generally, the case of Sri Lanka again underscored the difficulty of predicting the dynamics of inflation, particularly in programs involving significant exchange rate action and discrete price corrections.

With respect to fiscal policy, the substantial reduction in real recurrent spending appeared somewhat ambitious--all the more reason not to allow revenue performance to deteriorate, Mr. Ahmed commented. Clearly, tax reform was necessary and welcome, but there was no apparent reason why such reform should not be at least revenue neutral.

Sri Lanka's economic prospects included a number of uncertainties, Mr. Ahmed said. The domestic security situation was obviously a major one. However, barring any deterioration in that connection, persistence in following prudent financial and structural policies should enable Sri Lanka to attain relatively high levels of growth and a sustainable balance of payments position, notwithstanding the implications of the Middle East crisis, which, though significant, did not appear to be uncontainable.

The Deputy Director of the Asian Department commented that, in considering whether the monetary target for 1991 was too high in light of the inflation target of 10 percent and the growth target of 4.5 percent, it was necessary to look at the average rate of inflation. Although the paper specified an inflation target of 10 percent at the end of 1991, the average rate of inflation during the year would be considerably higher. Combining the average rate of inflation and the growth rate, the growth of nominal GDP is projected to be considerably higher than the target for the growth in liquidity of 15 percent.

As to government expenditure, the target of retrenching up to 20,000 government employees was achievable; 10,000 employees had already been retrenched, the Deputy Director remarked. However, retrenchment plans became more difficult to implement as the number of retrenched employees increased. The Government, together with the World Bank, was developing a program for retrenchment for the next few years. With respect to defense, the decision to increase expenditures would be reversed if the situation improved.

Balance of payments analysis of the Middle East crisis involved not only oil imports, but also remittances, which were more difficult to project, the Deputy Director explained. Using the recent oil price assumptions and certain assumptions on remittances, the current account deficit was estimated to deteriorate by another half a percentage point of GDP in 1990 and perhaps close to 1 percentage point in 1991. However, a number of other factors would work to strengthen the current account position--considerations presented in the last paragraph of the supplement. The staff would like to review the projections with the authorities at the next opportunity.

With respect to the use of the CCFF, in late August and early September the staff had conducted preliminary studies on the applicability of that facility based on assumptions on oil prices presented in the world economic outlook and using some hypothetical assumptions regarding the modification of CCFF policies discussed at that time, the Deputy Director of the Asian Department remarked. The exercise had concluded that there was no major shortfall to be covered. At the same time, the staff did have some informal and very preliminary discussions with the authorities on the mode of various types of financing, including the possibility of a CCFF drawing and an arrangement under the ESAF. The authorities indicated informally, on the basis of preliminary information, that they preferred to receive assistance through an arrangement under the SAF and ESAF in support of their long-term reform efforts. They also indicated that they were confident of receiving such support, because their reforms were proceeding well, as was mentioned in Mr. Fernando's statement.

The Deputy Director of the Exchange and Trade Relations Department said that, partly in light of the Middle East crisis, the staff generally felt that appropriate contingency arrangements should be included in Fund arrangements. In the case of Sri Lanka, an arrangement under the SAF had been negotiated before the developments in the Middle East. The Deputy Director of the Asian Department had said that, in a sense, a contingency had been introduced--at least on the policy side and to some extent on the financing side--because there had been further adjustments beyond those negotiated. With respect to a forward looking contingency in association with the SAF, the SAF itself was not a very good vehicle for the attachment of a contingency arrangement, essentially because such arrangements involved not only financing provided by the Fund, but also program modifications and offsetting adjustments. The SAF itself did not provide a good framework, because the disbursements were up front, there was no provision for a program review, and there were no performance criteria to test and modify and to use to adjust the program in midstream, along with the implementation of the contingency arrangement.

Another factor was the cost of the Fund's regular resources under contingency financing in connection with the CCFF, the Deputy Director noted. A more concessional rate of charge would be highly desirable in this case and potentially possible, given the continuing consultations with respect to a subsidy account. Fundamentally--as Mr. Fernando's statement indicated--the authorities were very interested in moving to an arrangement under the ESAF at an early date. If an appropriate program could be developed, the staff would certainly see it as a feasible and desirable means of helping Sri Lanka to adjust to current circumstances.

Mr. Fernando remarked that his authorities had fully understood the concerns about whether undue emphasis on the exchange rate to maintain export competitiveness could have given an impetus to inflation, which was at the center of their concerns. In fact, during the first half of 1990, the rupee-dollar nominal exchange rate had remained constant. During that period, the inflation differential vis-à-vis both trading partners and export competitors had caused an appreciation of the real effective exchange rate.

In the interesting empirical analysis attached to Annex 1 of the background paper, controlling inflation in a "moderate inflation" developing country like Sri Lanka had been shown to pose problems that were far more severe than were encountered in a country where the financial sector was more developed or in a developing country where inflation was high, Mr. Fernando explained. Time lags between reactions and results were longer, and the contribution of monetary factors to price changes were observed to be less than one. Inflationary expectations and structural factors in the financial sector were important matters to be taken into account in determining the policy response.

His authorities fully agreed that the maintenance of export competitiveness was best pursued by controlling domestic demand and cost-push factors, Mr. Fernando said. If the time lag involved put export competitiveness at risk--especially if the balance of payments was still considered fragile and external reserves remained too low--then some defensive action on the exchange rate might be indicated as a supplement to strong macroeconomic and structural policies. In the Chairman's summing up at the previous discussion on Sri Lanka, Directors had called for exchange rate monitoring based on balance of payments developments and international competitiveness. The modifications to the exchange market strengthened the hands of the Central Bank by depoliticizing the issue. Therefore, the Central Bank was in a better position to interact more effectively with the market. Directors' comments on using the exchange rate as a tool to maintain external competitiveness and the notes of caution to be heeded in operating the new exchange system were well taken.

The entire question of the size, composition, and direction of the public sector was related to the question of civil service reform, Mr. Fernando noted. The Government had already completed the work related to criteria for retrenchment and had undertaken measures to improve the efficiency of the public service. Retrenchment could be speeded up if incentives were granted, but there were budgetary constraints. Consequently, as the staff paper had indicated, emphasis was currently on natural attrition, reinforced by the hiring freeze. Retrenchment in Sri Lanka, it should be kept in mind, meant a loss of employment without either retraining facilities for redundant labor or social security benefits. Of course, a growing economy and strong sustained private sector activity would be the most effective lubricant. Further, a final settlement of civil strife would also make possible the rehabilitation of areas that had suffered physical damage. The funding either on a grant basis or on highly concessional terms, was already available, and a reconstruction program would provide an ideal offset to the obvious problems that would result from retrenchment. His authorities' hands had been strengthened in that context by policy-based lending from the World Bank, which was speeding up the thinning out of the civil service, as well as the broader public sector.

On a point raised by Mr. Fogelholm about whether red tape continued to hamper investment, most of the problems had been solved, Mr. Fernando responded. Safeguards for private property had been inserted in the constitution. In the event that the public sector must expropriate, effective, adequate, and timely compensation would be paid. Another deleterious piece of legislation that had remained in effect for about 12 years--the Business Acquisition Act--had been repealed in 1988. Over and above those reforms, an important indicator of government intentions had been the decision to open areas hitherto reserved for the state. For instance, banking had been thrown open about 12 years ago, and a number of financial institutions, both foreign and domestic, had been established. In the area of insurance, the government monopoly had been terminated about 18 months previously. At the same time, another monopoly, the bus service, had been regulated and the private sector had become involved in it.

As to more recent actions, both domestic and foreign investments were subject to screening procedures, institutionalized in two kinds of committees, the Local Investment Advisory Committee and the Foreign Investment Advisory Committee, Mr. Fernando observed. Procedures had been streamlined. One agency processed the paperwork required of foreign investors. With respect to portfolio foreign investment, the prohibitive tax on the transfer of shares--either between foreigners themselves or between locals and foreigners--had recently been rescinded by administrative means until the law could be amended to abolish it permanently. The authorities were continuing to ferret out all remaining bureaucratic impediments to investment.

Twenty-five of the 100 or so public enterprises were in an advanced state of privatization, Mr. Fernando noted. Negotiations with foreign investors had been either completed or were well advanced for 13 of them. Foreign corporate investment would amount to about 50 percent to 60 percent in each case.

With respect to the adequacy of financial sector reform, a number of measures were currently under way, Mr. Fernando remarked. Historically, the Central Bank had financed budget deficits. The Central Bank was expected to continue to allow treasury bill rates to be aligned with market rates through sales in the secondary market and sales to the nonbanking sector. A great deal of progress had been made in that connection until a year ago, but there was an ebb and flow in the level of net credit by the monetary authority to the Government. The third year SAF program included the authorities' aim of having interest rates be determined more by market forces. Toward that end, the bank rate had already been adjusted two months previously and continued to be adjusted. More recently, short-term treasury bill rates had been increased. As part of financial deregulation, longer maturity government paper of one year and more was expected to be issued shortly. The improvement in public finance conditions and the prospective repayments to the banking system would certainly be a strong impetus to move to a system in which monetary policy could be effected more through indirect than direct means.

Looking at the broader financial sector, the authorities were indeed very concerned about the cost of financial intermediation, which at 8 percent was very high by any standards and caused lending rates to exceed 25 percent, Mr. Fernando commented. With the current inflation, such lending rates could effectively dampen the supply response of the economy. The Government's response had included an overhaul and strengthening of the law relating to debt recovery. Similarly, loan recovery and loan classification procedures had also been strengthened, as had capital adequacy ratios. With a view to providing an impetus for the improvement of the financial sector, the law on the financial status of the nonfinancial public sector had been changed and enforcement procedures tightened. The authorities expected that financial sector reform would underpin their efforts at financial control in the public sector.

The Acting Chairman noted that Mr. Fernando had reminded the Board of the dual considerations of competitiveness and inflation in influencing exchange rate policy. During the Board's discussion of the 1989 Article IV consultation, more emphasis had been placed on the competitiveness issue, given the balance of payments developments that had taken place earlier--the growth in imports and fall in exports, the decline in receipts from tourism, and evidence of capital flight via the misinvoicing of trade. Concern had also been expressed at that time about the effects of a devaluation on the price level and the need to tackle inflation. Judging the right time to adjust the exchange rate to improve competitiveness was difficult.

The Acting Chairman made the following summing up:

Directors commended the progress made by Sri Lanka in stabilizing the economy, strengthening confidence, and restoring growth during the past twelve months in the face of unusually difficult political and social conditions. They attributed this progress largely to the tightening of financial policies and the structural reforms that had occurred in the context of the economic program supported by the second annual arrangement under the structural adjustment facility. Directors also noted that the authorities had responded quickly to the difficulties arising from recent events in the Middle East, in part through the pass-through of oil price increases. They stressed that, given the persisting high rate of inflation, the uncertain external outlook, and the country's still low level of external reserves, the authorities should continue strengthening underlying budgetary and monetary policies as well as structural reforms.

Directors noted the positive results of the authorities' recent efforts to strengthen the fiscal position. They encouraged the authorities to maintain--and indeed tighten--the stance in the 1991 budget to ensure that the stabilization gains made to date could be sustained. In particular, they stressed the need for continued restraint in the wage bill, reductions in budgetary transfers to households through better targeting of the key welfare programs, and containment of defense expenditures. With respect to the revenue side, Directors supported the authorities' intention to proceed with tax reform, but noted the importance of the revenue effort not being diminished as a result of such reforms. In the longer term, Directors observed that lasting deficit reduction could be obtained only through key structural reforms in the public sector. They emphasized the need for determined implementation of administrative reforms, improvement of the overall efficiency of the civil service, and reduction of employment in the public sector. They stressed that public enterprise reform, if more forcefully pursued, would have positive budgetary consequences and would make room for an increasing share of investment being borne by the private sector.

Directors expressed concern over the high rate of inflation and the weak stance of monetary policy in early 1990, and welcomed the tightening that had occurred in response to the acceleration in price increases and the less favorable external situation that had developed. However, to support a trend toward a lasting reduction in inflation, and at a pace more rapid than was contemplated by the authorities, Directors believed that it would be crucial to strengthen monetary and credit policies further. In this connection, they urged an early return to positive real interest rates. Directors also stressed the importance of financial sector reform, with a first step in that direction being the reduced use of quantitative controls in favor of greater reliance on indirect instruments of monetary management.

With respect to the exchange rate, all Directors emphasized that stronger efforts to reduce inflation through a sustained tightening of monetary and fiscal policy, together with accelerated structural reforms to improve competition, were needed to achieve exchange rate stability and maintain external competitiveness, as well as to sustain domestic output growth. A number of Directors discouraged a resort to nominal devaluation as a means of improving competitiveness and cautioned that such an approach could feed inflation and lead to unsustainable capital movements. Other Directors emphasized the importance of the authorities' monitoring external competitiveness and availing themselves of a flexible approach to the exchange rate as needed in order to avoid a loss in competitiveness.

Directors again stressed the importance of persisting with structural reforms, with particular attention placed on reducing the size and pervasive influence of the public sector. They welcomed the steps taken in this direction over the past twelve months. Emphasis should be placed on streamlining the civil service, tax reform, strengthening the public corporations, accelerating the privatization of public enterprises, and increasing the efficiency of public investment. A particular focus of attention should be the financial sector, including financial liberalization--especially of interest rates--and strengthening the operations and competitiveness of the state banks.

Directors observed that Sri Lanka's external position remained vulnerable and was being adversely affected by recent events in the Middle East. This was not only because of higher oil prices, but also because of the loss of private transfers and of the costs associated with the loss of employment of many Sri Lankans working in the region. It was hoped that foreign assistance would continue to be forthcoming on the requisite scale to help Sri Lanka cope with the effects of these disruptions. In this context, Directors stressed that the continuation of a sound and responsive approach to policy formulation was essential to maintaining external confidence, both among official donors and foreign private investors, and that it might also pave the way for Sri Lanka's possible access to an enhanced structural adjustment facility.

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

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

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

2. Sri Lanka's exchange system is free of restrictions on payments and transfers for current international transactions, except for the restriction arising from the limitations on the availability of foreign exchange for personal travel abroad, which is maintained in accordance with Article XIV, Section 2; and the multiple currency practice arising from a stamp duty of 3 percent on letters of credit for imports, which is subject to approval under Article VIII, Sections 2(a) and 3. The Fund encourages Sri Lanka to eliminate the restriction on travel allowances as soon as circumstances permit and urges the early removal of the multiple currency practice arising from the stamp duty.

Decision No. 9563-(90/151), adopted
October 22, 1990

Structural Adjustment Facility - Third Annual Arrangement

1. The Government of Sri Lanka has requested the third annual arrangement under the structural adjustment facility.

2. The Fund has appraised the progress of Sri Lanka in implementing the policies and reaching the objectives of the program supported by the second annual arrangement, and notes the updated policy framework paper contained in EBD/90/307.

3. The Fund approves the arrangement set forth in EBS/90/167, Supplement 3.

Decision No. 9564-(90/151), adopted
October 22, 1990

2. SAO TOME AND PRINCIPE - 1990 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1990 Article IV consultation with Sao Tome and Principe (SM/90/185, 9/21/90). They also had before them a background paper on recent economic developments in Sao Tome and Principe (SM/90/193, 10/11/90).

Mr. Santos made the following statement:

The staff report for the Article IV consultation with Sao Tome and Principe presents a fair and balanced assessment of recent economic developments and the policies that the authorities have been implementing since 1989. Notwithstanding the generally difficult environment in which their adjustment efforts are taking place, the authorities are determined to address the internal and external financial imbalances confronting the economy. In this context, they have accelerated the process of shifting the economy to a market-oriented one, liberalized trade and distribution systems, and have initiated a reform of their institutions. Since the authorities are in broad agreement with the staff appraisal and policy recommendations, I will only highlight some of the policies and structural reforms my Sao Tome and Principe authorities are implementing.

Directors might recall that on June 2, 1989 the Executive Board approved a three-year program under the SAF and the first annual arrangement thereunder to assist Sao Tome and Principe in its efforts at reforming the economy. This SAF program was preceded by a structural adjustment program launched in mid-1987 with the support of the World Bank and the African Development Bank (ADB). As indicated in the staff report, in spite of the commendable efforts made by the authorities, weaknesses in administrative capacity and limited experience in managing market-oriented reforms led to some slippages and delays in the implementation of policy and structural measures in some areas. As a result, economic and financial performance generally weakened in 1989 and some objectives of the program could not be achieved. Nevertheless, the authorities intensified their efforts and introduced corrective measures which should put the program on track.

In the real sector, growth performance in 1989 fell below expectations, with real GDP growing at 1.5 percent, reflecting primarily a decline in cocoa production. Indeed, the ongoing rehabilitation of the cocoa sector, supported by the World Bank, the ADB, and other bilateral partners did not lead to the expected strong growth in production, as cocoa prices in world markets continued to fall. In the circumstances, and given the importance of the cocoa sector in the economy, the authorities have intensified the rehabilitation of the agricultural estates and have adopted various measures to spur production. These measures include the replanting of cocoa trees, the strengthening of the management of the estates, the liberalization of cocoa exports, the reduction of the tax levied on cocoa exports, as well as the improvement and extension of transport and storage facilities.

Consistent with their objective of diversifying the economy away from cocoa, the authorities have launched two projects with foreign assistance to increase smallholders' production of vegetables and therefore reduce the country's reliance on food imports. These projects focus on agricultural research, seed dissemination, and improvement of extension services. In addition, a modern palm plantation financed by the EC is being developed. When production comes on stream by 1993, it should be able to meet domestic demand for edible oil. The authorities realize that the chances of success of their agricultural diversification program will be enhanced if a solution is found to the problem of land tenure. Notwithstanding the difficulties experienced in bringing redistributed lands into production, the authorities have reiterated their commitment to the land reform program. To this end, they are seeking assistance from the World Bank and the UNDP, with a view to adopting new legislation regarding property ownership rights.

The rehabilitation of the parastatals is considered a critical element in the authorities' strategy to promote growth and enhance resource allocation. Diagnostic studies of the 11 state enterprises were completed with technical assistance from UNIDO. Based on these studies, the Government has drawn up a plan of action to privatize or restructure public enterprises. Management of those enterprises selected to remain in the Government's portfolio will be strengthened.

In the fiscal sector, despite the adverse impact of the depreciation of the exchange rate on expenditures, firm control was exercised over all components of non-wage outlays, and current expenditures remained within the program ceiling. The slippages that occurred were mainly on the revenue side and were due to lower-than-programmed collections of import taxes, and smaller transfers from public enterprises to the Treasury.

The authorities are aware of the need to strengthen public finances and reduce the government deficit. Given the limited scope for action on the expenditure side, they are concentrating their efforts mainly on the revenue side, where there is room for additional measures. Therefore, revenue-raising measures were implemented in the first half of 1990 which include: increases in the tax rates on imported foodstuffs, petroleum products, alcoholic beverages, and tobacco products; higher excise taxes on locally produced beer and soft drinks; and the introduction of licenses and fees on civil aviation. In order to help achieve the revenue target for 1990, these measures are being complemented in the second half of 1990 by the reduction of import and export tax exemptions and increases in the rates of scheduled income tax and import duties. Furthermore, a comprehensive tax reform aimed at increasing the buoyancy of the tax system and broadening the tax base will be introduced in 1991.

In the monetary sector, the authorities have been concerned about the magnitude of the nonperforming assets of the National Bank and in May 1989 issued stricter guidelines on the extension of credit to address this situation. Moreover, in line with the comprehensive reform of the banking sector underway, a new charter and a new accounting system for the National Bank will be adopted soon with a view to strengthening its role as a central bank. With respect to interest rate policy, and following the rollback of some of the previous increases in nominal rates, it is the authorities' intention to achieve positive real interest rates through a reduction in the rate of inflation.

With respect to exchange rate policy, it is to be noted that the cumulative depreciation of the dobra between July 1987 and end-1989 amounted to 280 percent in local currency terms. Although this depreciation has helped to strengthen the financial position of the cocoa sector, it has had an adverse impact on inflation and the external public debt. Nevertheless, the authorities have reaffirmed their commitment to a flexible exchange rate policy and they will continue their efforts to reduce the spread between the parallel and the official rates.

Finally, my authorities recognize that Sao Tome and Principe's medium-term prospects will remain difficult. They are aware that the continued fall in world prices of cocoa and the increases in oil prices do not allow for a relaxation of their adjustment efforts. Moreover, the servicing of the external debt continues to put a heavy burden on the economy. The authorities expect that at this critical juncture in the reconstruction of their country and the rebuilding of their institutions, strong support from the international community will be forthcoming to assist in their efforts.

Mr. de Groote made the following statement:

It is discomforting to note that none of the three major macroeconomic objectives announced for the 1989-91 programs has been implemented: GDP increased less than half of the announced 4 percent target, inflationary pressures have stayed around 30 percent, and the external current account deficit, instead of being reduced, has reached the staggering figure of about 80 percent of GDP. As the staff notes, many of the quantitative targets in terms of fiscal and monetary policy were not met, and some key structural reforms are well behind schedule. Notwithstanding such a negative assessment, I can go along with the staff appraisal that the Government of Sao Tome and Principe has made significant strides toward a more flexible market-based approach to economic management. I equally welcome the authorities' efforts to put their adjustment program back on track, as evidenced by the establishment of a well-defined package of financial and structural policies to be implemented in 1990.

Nevertheless, I still feel uncertain as to whether the announced policy package will suffice to put the adjustment program on track again. First, I notice that a number of policy slippages in 1989 stemmed mainly from a weak administrative capacity and from a limited experience in managing market-oriented reforms. I would like to stress in that respect the staff's view that more should be done at the outset in terms of strengthening the institutional capacity of the government as well as in terms of defining the government's overall role in the economy. It would be regrettable if these shortcomings were to prevent once again the establishment of a track record of successful program implementation. It could, moreover, entail a loss of credibility for the Government abroad, with possibly grave consequences with respect to the willingness of donors and creditors to cover the large financing gaps projected over the medium term at a time when external financing is being asked for all over the world.

The second and main reason why I feel uncertain about the sufficiency of the announced policy package has to do with its contents; allow me to briefly comment on the fiscal, monetary, external, and structural aspects of these policies. As to the fiscal policy, I wonder whether a deficit reduction in 1990 of 0.5 percent in terms of GDP--from 9.2 percent to 8.7 percent--is forceful enough, although I admit that the effort is more sizable when excluding scheduled interest payments. Is current expenditure not growing too fast, just as capital expenditure was growing too fast in 1989, and can this evolution not be linked to the upcoming elections? Does the staff not feel that even on the expenditure side of the budget, there is more latitude for adjustment if one presses ahead with scaling down the role and size of the central administration, which shows considerable overhead costs? Turning to the revenue side, the tax reform measures elaborated with Fund assistance need to be implemented as soon as possible, given the fact that the amount of transfers received from public enterprises will dwindle. Indeed, the National Bank's profits are in a sense only accounting profits and they will disappear once the banking reform is pushed through and the oil import and export company's (ENCO's) profits will be seriously affected by a change in the supply prices of petroleum products, especially if the authorities refrain from a full pass-through to final users of the recent oil price rises--an interesting subject that we have already frequently discussed in the Board.

In considering the monetary policy part of the reform program for 1990, one feels at first comforted by the slow growth of broad money, which would lead one to expect that inflation would be reduced and that the way would be paved for positive real interest rates. But, when one then discovers further that broad money growth on average was even lower than in 1988 and 1989 combined, and that inflation soared nonetheless, not much remains of that first comfortable feeling. I would like to hear the staff's comments on the factors behind the surge in money velocity which is implied by this evolution.

Turning to the third subset of measures in the 1990 policy package, the external sector, not much improvement in the external balance can be expected to result from those measures. Even the 1995 current account deficit projection of about 40 percent of GDP represents a worse result than the 1987 outcome, and it does not even fully take into account the recent increase in oil prices. Therefore, I would assume that additional efforts are called for if the country wants to stay out of a vicious circle where it lacks sufficient external funds to finance its investment needs, a situation which leads to slower growth and negative GDP per capita growth, and a result which in turn leads to emigration and therefore drains on the potential stock of domestic savings, necessitating even more external resources. Additional efforts to avert such an outcome need, in my view, to be focused on the issue of diversification--first in terms of export products where activities such as fishing, tourism and possibly coffee production offer a potential for the country to steer away from the cacao monoculture, if my interpretation of the background paper is right. Diversification is also needed in terms of trading partners; I was particularly surprised to note that the two Germanies accounted for close to 60 percent of Sao Tome and Principe's exports in recent years. What will German reunification mean in this context? Can we expect that the eastern region of Germany will continue to import the same amount as it did under the bilateral trade agreement that existed with the Democratic Republic, which obviously re-exported a quantity to other Eastern and Central European countries. Diversification is also needed in terms of financial assistance, where the staff rightly points to the possibilities of more foreign direct investment and more careful selection of investment projects.

Addressing the fourth and final issue of the 1990 policy package--the structural reform measures--the Government, in my view, should proceed forcefully with its land reform program, taking care especially of the supporting infrastructural, agricultural, and banking services to ensure a decisive domestic supply response to the incentives already offered, such as trade and price liberalization and the incentive of exchange rate adjustment. Qualitative information available concerning the production of maize, as described in the background paper, suggests that such an approach can yield important successes. Whether exchange rate adjustment should play a more active role in this respect is an issue that is broadly left open in the staff report. It is not clear what the final answer should be. On the one hand, the sensitivity of public expenditure to exchange rate changes pleads against proceeding too fast with a reduction in the spread between the official and parallel market rates. On the other hand, a successful export drive can only be achieved with realistic price mechanisms, including a realistic exchange rate. I would appreciate staff comments in this respect, especially in view of the rather bleak medium-term external outlook.

To conclude, all the points I have stressed in one way or another relate to the difficulties facing Sao Tome and Principe in removing the rigidities that unavoidably accompanied the policy options that were taken after independence. Let me therefore express the hope that the country's authorities will succeed in joining the world-wide movement to build development on more market-based mechanisms.

Mr. Serre made the following statement:

I endorse the thrust of this comprehensive and candid staff report. It is, indeed, clear that the authorities' strategy--

supported by the SAF and the 1987 and 1990 structural adjustment credits of the World Bank--has been consistent with the need to address the deep-seated distortions which affect the economy. However, it is also clear that the case of Sao Tome and Principe demonstrates the necessity of adopting a far-reaching approach focused on structural policies, because the economy relies on a single export crop and on imports to meet the basic needs of the population. During the Board's June 2, 1989 meeting on Sao Tome and Principe's request for a three-year arrangement under the structural adjustment facility and the first annual arrangement thereunder (EBM/89/69, 6/2/89), some chairs raised the question of the adequacy of a Fund-supported program in such a context. My chair still believes that Fund advice remains essential in designing a sound macroeconomic framework--especially after the weak performance observed in 1989, which resulted from slippages in policy implementation. Therefore, I shall focus my comments on structural policies and on the external sector.

As to structural policies, I, like Mr. de Groote, think that the diversification of agricultural production, especially the domestic food crop, is of paramount importance in order to increase the growth rate significantly in the future. Given the high potentiality of the agricultural sector, we urge the authorities to accelerate land tenure reforms to favor agricultural smallholders.

Concerning public finances, in light of the low level of taxation, the mobilization of resources urgently needs strengthening with technical assistance provided by the Fund. Of utmost priority, the ongoing process of civil service and public enterprise restructuring must be pursued more actively. Finally, given the slippages that occurred in implementing the public investment program, I urge the authorities to devote sufficient attention to those developments that both undermine the credibility of the adjustment process and increase the magnitude of the problems facing the country.

On the positive side, I note with satisfaction the progress already achieved in trade and price liberalization and in a market-based approach to economic management that allows more room for the private sector. However, further progress is undoubtedly needed to improve the overall efficiency of the economy in a durable and sustainable manner. In this respect, the reform of the banking sector should be implemented without delay to support the adjustment process effectively.

Turning now to the external sector, I agree with the staff that, in the absence of external viability over the medium term, the country deserves special consideration by the international financial community. I also note that the policy package for 1990 still relies on adjusting the official exchange rate in order to reduce the spread between official and parallel market rates. Further tightening of fiscal and monetary policies will support this objective. I wonder, however, whether a second-best approach should be followed in light of the present weak administrative performance. Discretionary adjustment has led to financial instability, principally with respect to import prices, budgetary expenditures, and salaries. Therefore, I wonder whether, in the present situation and given the fact that primary commodities constitute the totality of exports, a policy of firmly pegging the nominal exchange rate at a realistic level would not be preferable, in order to provide an anchor for inflationary expectations and a framework for financial and monetary discipline. I would appreciate any comments from the staff on this matter.

To conclude, I encourage the authorities to pursue the dialogue with the Fund and to seize the opportunity of the 1991 budget discussion to reinforce the policy package elaborated in 1990. We stress the need for the measures described in the report to be implemented simultaneously in order to achieve the best results. We support the proposed decision.

Mr. Ishikura made the following statement:

In mid-1987, Sao Tome and Principe initiated a structural adjustment program, following the severe economic difficulties caused by the economy's structural fragility that was a result of the dependence on a single crop--cocoa--and by the Government's limited administrative capacity. Subsequently, the scope of the adjustment program was expanded with the policy framework paper covering the period 1989-91, under the three-year arrangement under the SAF. Under the program implementation so far, there has been some progress in rehabilitating some of the cocoa plantations, eliminating consumer subsidies on imported foodstuffs, and liberalizing the trade system. Nevertheless, the program implementation was unsatisfactory with respect to key macroeconomic benchmarks and to structural reforms. It is disappointing that the SAF program eventually went off track as a result of these slippages, and there was a delay in restoring the adjustment program.

As to specific policies, I am in broad agreement with the staff's appraisal and support most of the policy recommendations. With respect to fiscal policies, a reduction of the overall deficit is essential. The projections for 1990-95 indicate that the large deficit will continue during this period. Furthermore, I am concerned about the vulnerability of the fiscal deficit to the international cocoa price. In light of such a fragile fiscal structure, the authorities should make every effort to increase revenue and contain expenditure.

On the revenue side, the authorities implemented or scheduled a series of tax measures this year, including an increase in several tax rates, the introduction of licenses and fees on civil aviation, and a reduction in tax exemptions. Although it is too early to judge whether these measures will be sufficient, it is essential to continue to monitor revenue performance closely--a commitment the authorities have already made.

On the expenditure side, as the staff appraisal noted, although restraint with respect to the wage bill is the most important factor in current expenditure, there will be political pressure to compensate government employees for the increase in the cost of living. As for capital expenditure, the authorities should have a strict policy permitting only essential investments.

With respect to monetary policy, because inflationary pressure is anticipated to continue, owing to the elimination of price controls and the depreciation of the exchange rate, the Government should maintain restrictive monetary and credit policies. Furthermore, it is disappointing that real interest rates remain broadly negative--notwithstanding the increases in the nominal rates in the past few years. Nominal rates should be adjusted further to achieve real positive levels, in order to strengthen domestic savings.

With respect to structural adjustment policies, I share the staff's concern over the delay in land reform and the restructuring of public enterprises and the banking system. These structural reforms, I believe, are the key to growth and development in Sao Tome and Principe. Although agriculture, especially cocoa production, will continue to be the most important sector, the economy needs to be diversified in order to reduce the fragility resulting from reliance on a single crop. In this respect, although I note that the background paper refers to the failure of industrial fishing in the past, I would appreciate hearing the staff's comments on the possibility of developing the fisheries sector in the future.

As to exchange rate policy, I agree with the staff that the authorities should address the continuing spread between the official and parallel market exchange rates. This being said, I would like to also emphasize that any devaluation should be accompanied by tighter financial policies aimed at reducing the inflation rate and achieving stability in the exchange market.

The balance of payments difficulties will undoubtedly continue in the coming years, and the Government will need to request highly concessional external financing and debt relief. To this end, the Government should ensure the confidence of multilateral and bilateral donors by adopting more cautious external borrowing policies.

Finally, with respect to the access to the Fund's financial resources, in view of the rather disappointing track record under the first annual arrangement, I cannot help feeling concern about the authorities' ability to pursue the adjustment program in a sustainable and timely manner. In addition, I am concerned about the still fragile economic structure. As prerequisites to a new annual arrangement, I would like to emphasize the importance of strengthening the structural adjustment momentum and establishing a fair performance record under the 1990 economic policy package.

I will go along with the proposed decision.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/90/150 (10/15/90) and EBM/90/151 (10/22/90).

3. MOROCCO - STAND-BY ARRANGEMENT - WAIVER OF PERFORMANCE CRITERION

The Fund decides that Morocco may, notwithstanding paragraph 4(a) of the stand-by arrangement, proceed to make the second purchase for SDR 24.0 million under this arrangement. (EBS/90/174, 10/11/90)

Decision No. 9565-(90/151), adopted
October 18, 1990

4. PORTUGAL - 1990 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate

Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board agrees to extend the period for completing the 1990 Article IV consultation with Portugal to not later than October 26, 1990. (EBD/90/337, 10/15/90)

Decision No. 9566-(90/151), adopted
October 18, 1990

5. SAO TOME AND PRINCIPE - 1990 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board agrees to extend the period for completing the 1990 Article IV consultation with Sao Tome and Principe to not later than October 22, 1990. (EBD/90/338, 10/15,90)

Decision No. 9567-(90/151), adopted
October 18, 1990

6. SAUDI ARABIA - 1990 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board agrees to extend the period for completing the 1990 Article IV consultation with Saudi Arabia to not later than November 19, 1990. (EBD/90/339, 10/15/90)

Decision No. 9568-(90/151), adopted
October 18, 1990

7. SRI LANKA - 1990 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board agrees to extend the period for completing the 1990 Article IV consultation with Sri Lanka to not later than October 22, 1990. (EBD/90/340, 10/15/90)

Decision No. 9569-(90/151), adopted
October 18, 1990

8. BULGARIA - TECHNICAL ASSISTANCE

In response to a request from the Bulgarian authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/90/336 (10/15/90).

Adopted October 18, 1990

9. ACCESS TO FUND ARCHIVES

The Executive Board approves the proposal to allow access to the Fund's archives in connection with a study on the work of Raul Prebisch, as set forth in EBD/90/334 (1/13/83).

Adopted October 19, 1990

10. ASSISTANTS TO EXECUTIVE DIRECTORS - COMPENSATION SYSTEM - GUIDELINES AND TRANSITION ARRANGEMENTS

The Executive Board approves the proposals recommended by the Committee on Executive Board Administrative Matters relating to the guidelines and transition and grandfathering arrangements for implementation of the compensation system for Assistants to Executive Directors. (EBAP/90/264, 10/16/90)

Adopted October 19, 1990

11. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 90/1 through 90/5 are approved.

12. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/90/255, Sup. 1 (10/17/90), EBAP/90/262 (10/15/90), and EBAP/90/267, Cor. 1, (10/18/90), by Advisors to Executive Directors as set forth in EBAP/90/262 (10/15/90), and EBAP/90/267, Cor. 1 (10/18/90), and by an Assistant to Executive Director as set forth in EBAP/90/260 (10/12/90) is approved.

APPROVED: August 29, 1991

LEO VAN HOUTVEN
Secretary