FOR AGENDA

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January 29, 1988

To: Members of the Executive Board

From: *The Secretary*

Subject: Sri Lanka - Policy Framework Paper, 1988-90

Attached for consideration by the Executive Directors is the policy framework paper under the structural adjustment facility for Sri Lanka which will be brought to the agenda for discussion on a date to be announced.

Mr. Singh (ext. 7321) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

SRI LANKA

Structural Adjustment Facility

Policy Framework Paper, 1988-90

Prepared by the Sri Lankan authorities in collaboration with the staffs of the Fund and the World Bank

January 29, 1988

I. Economic Background and Adjustment Issues

1. Sri Lanka is a small island economy with a population of 16 million and a per capita income of about US$350. Sri Lanka is well known for its social achievements (in areas such as life expectancy, infant mortality rates, nutritional levels, school enrollment ratios, and literacy rates) which have traditionally been far superior to those found in countries at its level of development. Food distribution programs and social services designed to reach the poorest segments of society and virtually all areas of the country explain the country's success in developing human resources. These policies have also helped limit urban migration and over two-thirds of the population still live in rural areas. Agriculture provides the main occupation for over half of the labor force, but higher growth in the manufacturing and service sectors will be essential to restore Sri Lanka's growth potential and resolve its chronic unemployment problem.

2. The heavy dependence of the economy on exports of tea, rubber, and coconuts made it vulnerable to the declining trend in the world prices of these commodities. Consequently, there was a gradual erosion of the country's achievements during the years that preceded liberalization in 1977. With a view to safeguarding the living standards of the poor, successive governments resorted increasingly to controls, which distorted prices, affected incentives, and misallocated resources. The resulting low economic growth generated massive unemployment and made it difficult to maintain the impressive welfare system.

3. After two decades during which the economy was gradually closed, and the role of the Government expanded to a level where the private sector and markets had no role in allocating resources, the thrust of economic policy shifted in 1977 to a more open, market-oriented, environment. The 1977 reforms were remarkable in that they made fundamental changes in policies in a relatively short period of time: virtually all price controls were lifted, the financial and agricultural sectors were deregulated, and the trade and foreign exchange regime was liberalized. In response to these changes, there were marked increases in investment, growth, and employment.

4. However, the liberalization process did not entirely resolve the structural constraints to growth that were created during the long years of the controlled economy. First, uncertainties associated with the growing civil strife dampened private activity and, given the extremely small capital market, the Government could make only limited progress in transferring public enterprises to the private sector. Second, although the initial moves to liberalize trade and reduce protection were substantial, further progress was hampered, partly as a result of the emergence of protectionist policies overseas. Thus, many domestic industries stayed oriented to the small domestic market, constraining growth and employment performance. Third, while the liberal trade and foreign exchange regime established after 1977 laid the foundations for a more diversified export sector, its development was constrained by an exchange rate that appreciated in real effective terms during the first half of the 1980s. Nevertheless, there has been some diversification of exports because of other incentives. The garments export sector has developed very rapidly and has even surpassed tea as Sri Lanka's main export, but its import content has remained large at close to 70 percent. Thus, exports of traditional agricultural products (tea, rubber, and coconuts) continued to be the country's most important source of net foreign earnings.

Fiscal and external imbalances

5. The structural constraints were aggravated by fiscal imbalances. After 1977 with a view to rehabilitating a rundown economy, the Government had to undertake a massive public investment program (concentrating on irrigation, power, and housing) that peaked at 15 percent of GDP in 1980-82 and then declined gradually to 12-13 percent in 1983-87. This added to the pressures on an already overextended public sector and, despite a relatively high tax-GDP ratio of 20 percent, fiscal deficits rose to 18 percent of GDP in 1980-82, before gradually falling to 11-12 percent in 1983-87. The fiscal imbalances were accompanied by large external deficits. The current account deficit averaged 16 percent of GDP during 1980-82 with a gradual decline to about 10 percent of GDP thereafter. These macroeconomic imbalances had several adverse implications. They required the country's recourse to about US$900 million of commercial finance (about a quarter of the debt outstanding at September 1987), raised the debt service to 25 percent of current account receipts, and tended to crowd out an otherwise dynamic private sector.

6. In 1983, the Government attempted to address the macroeconomic imbalances and implement a stabilization program. However, the rapid escalation of the ethnic conflict precluded strong economic action and required the buildup of the security forces (defense expenditures, about 1 percent of GDP in the early 1980s, increased to 3-4 percent of GDP by 1985-86). Helped by the higher price of tea during the years 1983-84 and the decline in oil prices in 1986, the Government was able, nonetheless, to reduce the fiscal deficit to about 12 percent of GDP in 1984-87 by reducing development expenditures and freezing, in nominal

terms, certain current expenditures such as the fertilizer subsidy and the National Food Stamp Program. However, following a severe decline in the terms of trade since mid-1985 and the escalation of internal strife, the economic situation continued to deteriorate: the growth rate slowed to under 4 percent, unemployment increased to about 17 percent, and gross official reserves declined to the equivalent of under 2 months of imports.

7. The recent peace accord provides a unique opportunity to transform economic conditions, revive growth, and strengthen the balance of payments in the medium term. There should be an early revival of economic activity in the areas that have been affected by the internal strife. The Government has already decided to reduce defense expenditures in 1988 by some 2 percent of GDP and there should be an immediate easing of pressures in the balance of payments through the reduced imports of military equipment--which have constituted 5 percent of total imports in recent years. In the next 2-3 years, tourist arrivals can be expected to rebound to above their pre-1983 levels, i.e., a doubling over the 1987 number, while foreign investment could rise to two to three times the 1987 level. However, the reconstruction of the parts of the country affected by the ethnic conflict will put pressure on the budget. Some US$500 million will be necessary over a four-year period to restore normalcy to these areas, i.e., amounts equivalent to 1.5-2.0 percent of GDP annually during the program period. In addition, because little development activity has taken place in the north and east during the years of conflict, the need to have a more balanced interregional pattern of public expenditures is likely to generate new demands for public investment projects. Finally, while the devolution of power to the provinces should not necessarily require an increase in fiscal expenditures--since a basic decentralized administrative structure already exists--it is likely that the new structure will create some new fiscal pressure in the medium term. It should be possible, however, to accommodate these pressures and still achieve a sustainable fiscal balance since the reconstruction program is expected to be financed almost entirely through grants and highly concessional loans. Moreover, the Government is preparing a medium-term program of rationalization-cum-reduction in public expenditures that should allow the new demands on the budget to be accommodated without undue pressure on the economy. This program will be assisted by a World Bank mission which reviewed in late 1987 selected components of the expenditure budget; its recommendations will be part of the 1988 World Bank Country Economic Memorandum (CEM) on Sri Lanka.

II. Medium-Term Policy Framework

Macroeconomic objectives

8. The key macroeconomic objectives to be achieved during the adjustment period 1988-90 are:

(i) to restore growth to a sustainable 4.5-5 percent that should help reduce the unemployment rate;

(ii) to reduce inflation to about 5 percent, thus assuring financial stability; and

(iii) to reduce the current account deficit in the balance of payments from 8-9 percent of GDP in 1986-87 to about 6 percent of GDP--a level that can be financed without recourse to commercial borrowing--and restore gross official reserves to the equivalent of at least 2 months of imports.

Policy measures

9. To achieve these objectives, the Government has prepared a program of policy changes aimed at stabilizing the economy and at addressing the longstanding structural constraints to growth. At the heart of the adjustment effort is a reform of the public sector: its efficiency, its institutions, and its claims on resources. The public sector has been traditionally large in Sri Lanka but it has not generated growth and employment commensurate with the resources that it has absorbed. The purpose of the fiscal adjustment is to reduce wasteful expenditures; make public expenditure programs more efficient; and increase the role of the private sector in the economy. Equally important are measures to develop an outward-looking and internationally competitive industrial sector and promote exports. A flexible exchange rate policy is an essential component of such measures. Major components of the program have been announced in the report of the Industrial Policy Committee (IPC), approved by the Cabinet in February 1987, and in the November 1987 Budget Speech for the 1988 budget year. A list of specific policy measures, which indicates the timing of policy implementation, is provided in Table 1. This will be supported by annual programs during 1988-90.

10. Both the return to normal circumstances and the new policies to be introduced during 1988-90 should help achieve the key macroeconomic objectives of the adjustment program. Higher rates of growth are expected to be attained by the successful implementation of the peace accord that, as mentioned earlier, will create the conditions necessary for the resumption of normal economic activities in agriculture, fisheries, etc. and, in time, in tourism and foreign investment; by the reduction in the public sector domestic borrowing requirements that will release to the private sector resources now absorbed by the Government; and by the reorientation of industrial policies that will expand the opportunities for manufacturing growth. The improvement in the balance of payments situation and foreign exchange reserves will be brought about by the more flexible exchange rate policy; by the elimination of the taxation of nontraditional agricultural and marine exports; and by industrial policies that will create the incentives necessary for the manufacturing sector to be more export-oriented. Finally, the reduction in inflation will be achieved by the reduction in the fiscal deficit and the monetary policies to be pursued during the adjustment period.

Monetary and exchange rate policies will be reviewed annually to ensure that appropriate stimulus is being provided to the private sector.

Public sector adjustment policies

11. The aim of fiscal policy will be to reduce the overall budgetary deficit (before grants) from an average of 12 percent of GDP in 1986-87 to about 9 percent of GDP by 1990, a level that can be financed principally by grants and concessional foreign borrowing, with gradually diminishing recourse to domestic bank borrowing. This will reduce pressures in domestic financial markets enabling the private sector greater access to credit without risk to financial stability. Despite the accommodation of the reconstruction program, fiscal adjustment will be achieved primarily by reducing public expenditures from 33 percent of GDP in 1986-87 to 29 percent of GDP by 1990. Revenue policy will be targeted at preserving budget revenues at about 20.5 percent of GDP.

12. Adjustment in expenditures. The Government has prepared several major initiatives to reduce public expenditures and increase their efficiency. In addition to the reduction in defense expenditures that has already been decided for 1988, the Government is preparing, with the assistance of the World Bank, a program of further expenditure rationalization. Under the program both current and capital outlays will be examined with a view to identifying reductions or measures that would increase the efficiency of expenditures. The balance between current and capital expenditures and the adequacy of budgetary allocations for the social sectors are also part of this review (see paragraph 43). There are four main areas of expenditures where the scope for reductions is being examined.

13. The first is related to the civil service where redundancies have emerged with the reduction in the Government's regulatory role. Meanwhile, higher managerial ranks have come to be grossly underpaid, leading to difficulties in retaining better quality personnel and a lowering of public service standards. In addition, over the years, there has been a multiplication of ministries and agencies with fragmented and overlapping functions. The Government appointed a Presidential Committee on Administrative Reforms in 1984 that has now recommended: (i) a new salary structure to narrow the present wide disparity in remuneration with the private sector; (ii) eliminating activities that have become redundant and the overstaffing; (iii) reducing the number of entities with duplicate functions. The proposed new salary structure will be put in place over the two years 1988-89 with a total budgetary cost of about SL Rs 3 billion; it provides for proportionately larger salary increases for the managerial ranks in the public service. Even after this partial restoration of government pay scales, they would still remain below those in most public corporations and in the private sector. The Government is presently considering the other recommendations of the report regarding overstaffing in the public service. A timetable for their implementation during the second and third years of the program period (1989-90)

will be developed by December 1988 after the implications of the planned devolution of administrative functions to provincial councils are assessed. Meanwhile, the present freeze on creating new positions and the filling of vacancies will be continued.

14. Budgetary support to public corporations is the second area being examined by the Government. There are three public enterprises (Air Lanka, the Cement Corporation, and the Ceylon Shipping Corporation) which have absorbed over 1 percent of GDP annually in the last few years. The Government has already decided to reduce its budgetary support to Air Lanka in 1988. The rationalization of its operations and the disposal of assets has already reduced Air Lanka's need for budgetary support. The Government is also examining alternative proposals for the future of the airline that include: (i) curtailing uneconomic operations; (ii) restructuring its routes; and (iii) privatizing the airline. In the case of the Cement Corporation (also see paragraph 36), the Government is developing a restructuring plan together with the World Bank. The anticipated financial and technical restructuring under the plan would improve its efficiency and competitiveness. The restructuring plan will also attempt to attract foreign equity interest. The case of the Ceylon Shipping Corporation is more difficult. The company has suffered from the contraction in international sea traffic, the reduction in freight rates, and a large debt overhang. To minimize its need for budgetary assistance, the Government has already reduced the number of vessels from 14 in 1983 to 8 in 1986 and is prepared to make further dispositions if necessary.

15. The third area of expenditures being studied by the Government comprise subsidies and transfers, principally the fertilizer subsidy, the subsidies to the Central Transport Board (CTB) and the National Savings Bank (NSB), and the National Food Stamp Program. The Government is assessing the impact of the fertilizer subsidy on farmers' production costs and preparing a plan for its rationalization. The subsidy to the NSB is expected to decline over time with the reduction in the domestic borrowing requirement of the budget and, with it, the need for the NSB to invest in government securities. The Government does not intend to reduce the other two subsidies at this time. The food stamp program has a positive effect on maintaining the nutritional standards of the poorest segment of the population and the Government considers it important to continue to protect such groups during an adjustment period. Some streamlining of its operation to reach targeted indigent groups more effectively is, however, under consideration. With the return to normalcy, and the resumption of bus transport by the CTB in the areas affected by the strife, the subsidy to the CTB could be confined to the explicit losses associated with the few uneconomic routes that must be maintained for social reasons and with the travel by school children.

16. Finally, the Government intends to reduce the size of its Public Investment Program and it is currently analyzing the social and economic consequences of rephasing investment in irrigation schemes, power and transportation. These public investment projects account for close to

40 percent of development expenditures in the next five years. Concrete proposals will be developed during 1988 in light of the World Bank recommendations for implementation in the 1989 and 1990 budgets. Any new projects introduced in these areas will be consistent with the objective of reducing the size of the Public Investment Program.

17. Expenditure control and monitoring. In addition to developing the comprehensive plan to reduce public expenditure described above, the Government is already implementing a program to strengthen expenditure monitoring and control. Budget overruns and the need for supplementary allocations have been a recurrent problem in recent years that has rendered the attainment of fiscal targets difficult. The Government has thus put into place new and more effective rules for the monthly reporting of central government accounts and expenditures, with penalties for noncompliance or delayed reporting. Expenditure control has been strengthened by the establishment of rules on the timely end-year closure of accounts; prohibition of the carryover of unspent expenditure appropriations and of unapproved expenditure overruns; strengthening of budgeting and accounting procedures; strengthening of the reporting system for grants and expenditures out of grant resources; the review of treasury deposit and advance accounts and the elimination of many of these accounts; and improved procedures of cash accounting and management. Moreover, supplementary appropriations will be limited to the most imperative cases. Whenever such appropriations become necessary, the Government will offset their impact either by cuts in the allocations of other ministries or by additional revenue measures. Supplementary appropriations to absorb additional foreign aid will be allowed only when there is no need to increase the local appropriations in the budget, and consistent with the annual financial programs. In the case of public sector agencies and corporations outside the Central Government: (i) all additions to employment within and outside approved cadres will be reported monthly to the Treasury for review; (ii) external borrowing limits have been established for all public sector agencies and corporations and similar limits on domestic borrowing have been established for most institutions that are likely to borrow, in order to prevent unplanned expansions of expenditure programs; (iii) a strengthened procedure for the release of treasury advances has been instituted; (iv) there will be no government guarantees on borrowings for new projects of corporations and companies, except where mandated by bilateral and other aid procedures; and (v) any revisions to budgeted programs would be reported to the Treasury.

18. The monitoring of public sector agencies and corporations through the control of their financing flows, will be complemented by the establishment of a database for the financial accounts of the most important public enterprises and extrabudgetary units with a view to consolidating their financing needs with those of the Central Government. It is expected that, beginning in 1989, progress in this area will allow the Government to establish and monitor targets for the consolidated financial position of the Central Government and a specified number of public enterprises and extrabudgetary units.

19. Revenue policy. Low elasticity of tax revenues in relation to GDP is a major weakness of Sri Lanka's taxation system. The Government has been able to maintain tax-revenue levels as a share of GDP only through discretionary tax changes and excessive reliance on a narrow base of taxation, particularly international transactions. Thus, to prevent revenues from declining in relation to GDP, a comprehensive program to improve the elasticity of the tax system and to strengthen tax administration will be necessary. At the same time, there is a need to improve the efficiency of the tax system and, thereby, the incentives for production and investment. A program for achieving these goals has been developed that aims at expanding the domestic tax base while reducing the reliance on international trade taxes. The first elements of this program have been announced in the 1988 Budget Speech.

20. In the 1988 Budget Speech and effective November 18, 1987: (i) the reliance on international trade taxes was reduced by the elimination of export taxes on nontraditional agricultural and marine export categories, a 33 percent reduction in the specific export duty on tea, and a substantial tariff reform (section 34 below); (ii) a further simplification and reform of the income tax structure was announced, with a lowering of the maximum tax rate on personal income from 50 to 40 percent and a reduction in many tax exemptions; and (iii) the rate structure of the excise taxes was raised. In addition, it is planned to take steps, through the establishment of a register of firms, to broaden the coverage of business tax during 1988.

Monetary policy

21. Sri Lanka has a well developed financial system with a healthy degree of competition despite the dominant role of two large state-owned banks and the state-owned National Savings Bank. Since the 1977 reforms, positive real interest rates have generally prevailed facilitating the rapid growth of financial savings. Until recently, the Central Bank relied primarily on credit controls and reserve requirements to implement monetary policy. However, during 1986-87, a number of important financial reforms were undertaken to raise the efficiency of financial intermediation, develop the treasury bill auction, and increase the reliance on open market operations in the management of bank liquidity. Thus, more uniform and lower reserve requirements were established in August 1987 which, at 10 percent constitute a major reduction from the previous average level of 14 percent; most credit controls have been eliminated; and the feasibility of the elimination of the BTT on interbank transactions will be considered.

22. During the 1988-90 program period, further progress will be made in reducing intermediation costs through improvements in the efficiency of the two state banks. Toward this end, the World Bank is assisting in the development of a technical assistance program for the two banks. Among other measures planned are improvements in procedures for monitoring and forecasting treasury cash requirements and the expansion of the

treasury bill auction. New instruments of open market policy will be developed to give the Central Bank greater flexibility in managing the liquidity of the financial system.

23. Progressively during the 1980s, monetary growth rates have been reduced from 25 percent to about 10-12 percent, reflecting reduced fiscal deficits and greater effective control over monetary policy. Over the same period, inflation was halved to under 10 percent. During the adjustment period, the growth in monetary and credit aggregates will be held to levels consistent with the restoration of growth and the maintenance of relative price stability in line with the program. Annual financial programs will be drawn up for each year of the 1988-90 program period. Implementation will be guided by annual and quarterly benchmarks that will express the monetary objective in terms of aggregates the Central Bank controls, namely net domestic assets and credit to government. The planned reduction in the fiscal deficit, and in particular in the domestic financing requirement, is expected to allow a reduction in interest rates that would be supportive of growth without adding to inflationary pressures. Such a reduction in interest rates is also expected to result from the measures already implemented and planned to reduce intermediation costs.

24. Measures will also be taken to restructure certain nonbank financial institutions and to further improve banking supervision. In particular, a large number of small finance companies have recently encountered financial difficulties. The Government intends to consolidate these companies, which account for under 10 percent of all finance company assets, through rehabilitation measures, conversion of deposits into equity, and the setting up of schedules for the repayment of remaining deposits, with priority for small deposit-holders. In addition, legislation to strengthen further the supervision of banks and finance companies is being prepared. The Government also intends, with technical assistance, to strengthen its already-effective system of banking supervision by placing greater emphasis on longer-term financial analysis to detect potential problems at an early stage.

External policies

25. To promote stronger and more diversified export growth and achieve the external targets of the adjustment framework, a wide range of measures have been formulated. These include a flexible exchange rate policy, a tariff and licensing reform, and specific export promotion measures.

26. Exchange rate policy. In recent years, there has been much greater flexibility of exchange rate policy. The depreciation in the real effective exchange rate since 1985 has broadly offset the real appreciation that was experienced during 1980-84. During 1987 there has been a 10 percent real effective depreciation of the rupee against Sri Lanka's trading partners; against Sri Lanka's principal competitors, the real effective depreciation has been 5 percent. This has already enhanced

the country's competitive position and laid the foundation for achieving the export targets of the program. In the future, exchange rate policy will continue to be applied flexibly with a view to maintaining export competitiveness and restoring official reserves. In this way, exchange rate policy will seek to establish the incentive framework necessary to shift resources into export-oriented activities.

27. Tariff and licensing reform. A further tariff reform during the 1988-90 period has been announced in the 1988 Budget Speech that will achieve a reduction of the remaining high tariffs. At the same time, another major round of import and export liberalization has been implemented. These reforms are described in section 34 below.

28. Other export promotion measures. Since liberalization, Sri Lanka has developed a wide range of export promotion schemes aimed at allowing exporters access to tradable inputs at international prices; fiscal incentives, including direct cash payments, to exporters have also been provided. These have been considered necessary as a compensation for the disadvantages faced by Sri Lankan exporters vis-a-vis protected import-competing industries. The report of the IPC (section 33 below) recommends continued use of some export incentive schemes. In particular, it recommends that the access to tradable inputs at international prices provided by schemes such as the tax and duty rebate on imported inputs be extended to indirect exporters. The Government will implement this recommendation in 1988, thus providing the incentive for increasing the domestic value added of exports. Another recommendation of the IPC report--that related to the expansion of fiscal incentives--is being studied further because of its potential disadvantages that include high fiscal costs and the risk that they may be subject to countervailing duties under GATT; also, an expansion of fiscal incentives may be unnecessary in the context of a supportive exchange rate policy.

29. Among other export promotion policies, the Government: (i) intends to review the adequacy of exporters' access to competitive short-term credit finance; (ii) has simplified trade, banking and customs procedures in order to reduce the administrative costs of exporters, and has established procedures to review trade-related regulations on a continuing basis; (iii) has abolished most export licensing restrictions as well as export taxes on minor agricultural and marine products; and (iv) has already reduced the export duty on tea and will monitor the tax burden on the tree crop sector during the program periods to ensure an adequate return to producers.

30. Consistent with the recommendation of the IPC of promoting industrial exports, the Government has implemented a major liberalization of the gem industry to improve its competitiveness, increase value added, and promote exports. The gem industry was one of the last export sectors in Sri Lanka suffering from restrictions on the import of raw materials. The import of gems, gold, and other precious metals for jewelry exporters, which were previously subject to specific licensing for each shipment, can now be made freely by registered

exporters under general licenses issued annually. An agreement with Thailand, allowing the export of geudas (rough stones) has already been signed; for other unprocessed stones, the Government's policy is to encourage domestic processing. In 1988, the Government intends to extend the liberalization of these items to production for the domestic market. The Government also intends to restructure the State Gem Corporation to foster growth of the gem and jewelry industry.

Sectoral policies

31. In the last ten years, over two thirds of development expenditures have been allocated to public investment projects in agriculture (mainly irrigation in the Mahaweli areas) and power. This was in line with the Government's objectives of achieving self-sufficiency in rice and providing to the country a modern power generation and distribution infrastructure. These objectives have now been largely achieved and, for the future, it will be important to restore the balance of other priority areas such as rehabilitation programs for transport and social infrastructure and maintenance programs for small irrigation schemes. In the recent past, the Government has taken steps toward this end and has prepared several new projects aimed at rehabilitating and improving maintenance programs in the transport and health sectors. The World Bank is assisting the Government in this new initiative both through projects--one in health and one in transportation--and through economic work. As mentioned earlier, a review of public expenditures will be completed during the first quarter of 1988, in collaboration with the World Bank, that will assess, inter alia, the adequacy of the overall composition of public expenditures. Moreover, an irrigation strategy mission of the World Bank is scheduled for early 1988 to define and propose a long-term strategy for investment in irrigation. This mission should assist the Government in deciding what should be the future balance between large investment projects in Mahaweli areas, and investments aimed at rehabilitating and/or expanding existing small and medium irrigation schemes. In addition, this mission should also help the Government in securing adequate cost recovery in irrigation.

32. Since the liberalization in 1977, the Government has eliminated most restrictions and price distortions in the economy. Industrial policies are an exception as they still suffer from the inward-looking bias that guided policies before 1977. The major policy changes that are envisaged during the adjustment period are therefore related to industrial policies, including the public enterprises; in other sectors the focus will be on implementing established policies and programs. As a general principle, the Government will continue to follow full cost recovery pricing policies in all sectors. This policy is already in place in the energy sector, where petroleum prices and electricity tariffs are already at levels that ensure the full recovery of costs and substantial rates of return on capital. In the case of irrigation and water supply, measures to increase cost recovery will be developed in conjunction with World Bank missions scheduled for late 1987 and early 1988. For transportation, as mentioned earlier, a subsidy will be

retained to compensate the CTB for the losses incurred in uneconomic but socially necessary routes and in the transport of school children. The subsidy for railways is expected to decline following the implementation of the recommendations of the National Transport Study (NTS). The NTS recommends a number of tariff, institutional, and investment changes to rationalize transportation. These recommendations are now being discussed with the World Bank and will, in the near future, form the basis for a transport rehabilitation project. Finally, sectoral investment strategies and policies will be guided by the sectoral master plans that have been prepared in the last few years in the most important sectors of the economy: transportation, energy, health and agriculture.

33. Industrial policies. In December 1984, the Cabinet appointed an Industrial Policy Committee (IPC) to report on an appropriate industrial strategy for Sri Lanka. In December 1986, the IPC issued a report that was approved by Cabinet in February 1987. The report and its approval are major steps towards introducing policies that would allow Sri Lanka's industry and industrial exports to develop more vigorously. For the first time since liberalization in 1977, the Government has made explicit, in a comprehensive fashion, its industrial policy objectives and the strategies to be pursued regarding the trade regime, public sector manufacturing enterprises, and other areas of industrial policy. The IPC makes explicit recommendations to change the tariff system, to increase competition, and provide incentives for efficient import substitution and for manufacturing enterprises to become more export-oriented. The IPC report recognizes the vital importance of a supportive exchange rate policy for successful industrial policies. The report also recommends the privatization of the public manufacturing enterprises (PMEs), wherever possible, and improvements in the management of those that have to remain in the public sector for special reasons. Finally, the IPC has recognized that the lack of an adequate supply of credit to the export sector, particularly of short term credit for working capital, is a bottleneck in the development of exports and that the resolution of this financing problem should be a priority of export policy. In summary, the IPC report is a comprehensive document that provides an excellent basis to reorient industrial policies during the adjustment period 1988-90; the World Bank intends to support the implementation of its recommendations through several operations.

34. Tariff and licensing reform. The IPC stated the Government's intention to introduce a tariff system that would first, provide a moderate level of effective protection of around 50 percent and, second, would reduce the dispersion of effective protection rates among sectors. These objectives require changes in the structure of nominal tariffs. The first phase of the program was introduced in the November 17, 1987 budget speech and brings the maximum nominal tariff rate, now at 100 percent, down to 60 percent; in the case of luxury items where the tariff plays the role of an excise tax, tariffs may exceed 60 percent temporarily, but they will be replaced during 1988 by excise taxes once the excise ordinance has been amended. The minimum tariff rate has been raised to 5 percent with the exception of a few

items. The first phase of reforms also includes the elimination of the remaining import licensing requirements, except for a few that will be kept under license primarily for health, national security, or environmental reasons. The second phase of the program will take place after the ongoing study of effective protection is completed (expected to be in 1988) and will aim at bringing the maximum nominal tariff to 50 percent and introducing a four-banded tariff system. Such changes in the system would be revenue-neutral. The only exceptions to the maximum nominal tariff rate will be for cases of dumping where, upon recommendation of the Presidential Tariff Commission, specific duties would be applied on a case-to-case basis for specific periods of time.

35. Public manufacturing enterprises. The PMEs have been the source of a large number of distortions and have had a negative impact on Sri Lanka's industrial development. The IPC report recognizes this problem and proposes, as a general principle, that PMEs be sold to the private sector unless they have to remain public for special reasons; also, that enterprises may have to close down because they cannot be salvaged when exposed to a more competitive environment. However, since a privatization program will obviously require some time, the IPC proposes, in the interim, changes that would allow PMEs to operate with less government intervention and with greater competition.

36. In line with the IPC recommendations, the Government has prepared a program of PMEs reform consisting of two components--first, in 1988, transformation of 16 selected PMEs, the assets of which would be about half of the total value of PMEs' assets (excluding petroleum and cement) into public liability companies to prepare them for possible privatization. The shares of the converted companies will initially be divided between the Ministry of Finance and the line Ministries. These companies will be managed according to private sector rules: they will be free to determine their employment levels as well as the structure of their pay scales, and will not be subject to government tender and investment approval procedures. At the same time, with the 1988 budget, most remaining special privileges of PMEs have been removed. The Government intends to request World Bank assistance to finance a study assessing the effects of the removal of these privileges on the PMEs' finances and their viability in a more competitive environment. The study should be completed by end-1988.

37. The second component of the program will be the privatization of enterprises that can be partially or totally divested. There are three companies that are ready for total privatization, i.e., they are profitable, they are financially viable, and their size is such that their equity can be absorbed by local investors: State Distilleries, United Motors, and Ceylon Oxygen. The sale of shares of the first two of these companies will commence in mid-1988 and the third later in the year; all three will be completed by the end of 1989. Lanka Cement and Veyangoda Textile Mills (VTM) will have their equity shared between foreign investors, the Government, and state banks. Some foreign

investors have already been identified and negotiations should be completed, at least in respect of VTM, by the end of 1988.

38. Beyond this, the Cabinet has already decided to allow the entry of the private sector into the fields of telecommunications and insurance, areas of traditional public sector monopoly in Sri Lanka. Three new private insurance companies, some with foreign collaboration, have already been formed and should commence operations shortly. Previously, the Government had already removed the bus monopoly enjoyed by the Sri Lanka Transport Board and, now, about half of such transportation is handled by private operators. Also, in 1986-87, the Government sold or closed down seven unprofitable public enterprises or business units with a total employment of about four thousand persons.

39. Investment restrictions. Prior to 1977, all new investments required government approval. Although no such approval is now required for domestic investors, most continue to seek approval of the Local Investment Advisory Committees (LIACs) because it has typically improved their access to credit facilities and concessions. New projects with foreign participation are subject to approval by the Foreign Investment Advisory Committee (FIAC) and the degree of foreign equity participation allowed in each project is subject to negotiation depending, inter alia, on the degree of technology transfer and export orientation involved. The Government is of the view that the present system is sufficiently conducive to the speedy processing of investment applications, but will keep all procedures under review.

40. Energy. Energy is one of the areas that absorbed a considerable portion of public investment in the 1980s. Major multipurpose power projects under the accelerated Mahaweli Program have augmented electric power capacity by 60 percent during 1983-87, sharply reducing the reliance on generation from thermal sources using imported fuel. The Government intends to continue in the next three years its program of securing economically efficient supplies of energy to the economy. The major emphasis would be to improve the efficiency of the existing systems and reduce losses in power transmission and distribution. In addition, energy conservation measures would continue to be promoted through realistic pricing policies. Finally, power distribution systems would be rationalized and billing and collection procedures improved. The Government's objectives would be supported by the World Bank through its ongoing and future operations.

41. Agriculture. Traditionally, agriculture has been concentrated on the production of tree crops (tea, rubber, and coconuts) and paddy. The Government's main objectives in the medium term as set out in its 1984 National Agriculture Food and Nutrition Strategy, are to improve the productivity of tree crops, consolidate self-sufficiency in food and enhance the role of non-rice crops for import substitution and exports. The traditional export agricultural sector--tea, rubber, and coconuts--is benefiting from the major rehabilitation program initiated in 1984 and supported by the World Bank and the Asian Development

Bank. This program, which will continue during 1988-90, aims at increasing productivity through replanting and improved agricultural practices and strengthening production potential through increased investment. The tree crop sector is also benefiting from the enhanced flexibility in exchange rate policy and from a declining tax burden.

42. Although Sri Lanka is nearly self-sufficient in rice, it imports a range of secondary agricultural products which could be grown domestically. An important bottleneck in promoting other crops is the inadequacy of irrigation facilities and the limited availability of institutional credit. During the adjustment period, the Government would formulate a strategy to promote more efficient use of the irrigation potential in the country along with policies to increase the coverage of agricultural credit. Further, a Council of Agricultural Research Policy has been established with World Bank assistance to guide various research agencies within a coordinated framework. This should enable the Government to reorient research priorities to promote development of technology for export crops. In addition, the Government plans to remove distortions, such as the fertilizer subsidy (presently equivalent to about 0.3 percent of GDP) which, as a first step, will be further reduced during the program period. Also in line with the policy of progressive entry of the private sector into the sugar trade, in 1987, the Government completely disengaged itself from the import and domestic trade in sugar.

43. Social sectors Resources allocated to health and education have been gradually declining, from 5 percent of GDP in 1980 to 3.6 percent in 1985. There has been an even greater deterioration in the coverage of preventive medicine that reaches a wider section of the population. In education, there has been a serious erosion in the remuneration of teachers, and an increasing disparity between the content of curricula and the needs of the job market. A World Bank health project planned for early 1988 is geared towards improving management and cost effectiveness in the health sector, as well as revitalizing the family planning program. The adequacy of budgetary allocations for health and education will be analyzed in the public expenditure review mentioned in paragraph 7. On the other hand, resources for the housing sector have broadly increased in line with overall growth and Sri Lanka has one of the most innovative and efficient housing programs in the developing world. It is targeted to the poor, it emphasizes low cost indigenous construction methods, and it is based on self-help. Problems associated with low interest rates and recovery rates are being addressed and the Government has succeeded, in a pilot-program, to increase recovery rates by the use of national and saving thrifts societies. The Government is considering expanding the program through these societies and, thus, covering a larger portion of its housing program.

Social impact of the adjustment program

44. The adjustment program has been designed to restore a growth and employment momentum while reversing the erosion in social and welfare services and protecting the indigent in society. A major focus of the public expenditure reform is to reverse the declining trend in resources for health and education services and to enhance the efficiency of these services. In addition, the reconstruction program will have an important and direct impact on improving social services to the population in the north and the east. About a third of the reconstruction program is targeted towards rehabilitating houses, schools, hospitals and health centers in these areas, with the objective of restoring the quality of social services that existed before the ethnic conflict to a population estimated at about 1.5-2.0 million, i.e., 10-13 percent of the country's population.

45. The adjustment program incorporates mechanisms to protect the indigent. As discussed earlier, the Government will maintain subsidies directly targeted to the poor, such as the National Food Stamp Program, and subsidies such as for bus transportation and for infant milk food that also have an important impact on the real incomes of the lowest income groups. The adjustments in the public expenditure program that are being contemplated do not have adverse income and employment effects on the lowest income groups. Thus, the rehabilitation efforts for the Cement Corporation and the national airline would have minimal effects on employment. Other adjustments to the expenditure program are likely to affect projects that are capital-intensive and long gestation in nature, again with little significant effect on incomes and employment. Finally, the adjustment program is taking place at a time when the ethnic conflict is coming to an end and donors are prepared to finance a sizable reconstruction program under highly concessional terms. The end of the ethnic conflict should give a new impetus to the economy, increase employment and incomes in the labor-intensive tourist industry and stimulate foreign investment in both manufacturing and services, important sources of employment. Preliminary indications suggest that the reconstruction program will add new expenditures of close to 1.5-2.0 percent of GDP annually. Since an important part of this program consists of unskilled, labor-intensive construction activities related to the rehabilitation of housing, irrigation canals, roads and other types of infrastructure, it is estimated that the direct impact of the program will reduce the unemployment rate by one half of one percentage point while the indirect effect could be two to three times as high.

46. The overall stimuli to growth and employment that would follow from the adjustment program could offset and absorb much of the excess employment that may result from the industrial restructuring that is planned under the program. Moreover, restructuring of the civil service will only be initiated in the second year of the program, when it is expected that a measure of momentum in growth and employment has been regained.

External financial requirements, 1988-90

47. Medium-term projections of the balance of payments have been developed incorporating the effects of the cessation of the civil conflict. A gradual reduction in defense-related imports and the restoration of business confidence underlie the projections. The reconstruction program has an important role in financing the balance of payments, since its foreign financing is expected to largely exceed the import content of the program. A special Aid Group focusing on reconstruction, chaired by the World Bank, met in early December. At the meeting, commitments of nearly US$500 million were pledged for the reconstruction program.

48. Implementation of structural adjustment is expected to result in a gradual revival in export growth as well as a diversification of exports. Thus, after declining in recent years, exports are projected to grow by about 10 percent in nominal SDR terms in 1988-90. Similarly, after a compression during 1984-87, imports are expected to grow with the recovery in 1988. In aggregate, imports would remain roughly constant, as a percent of GDP, in 1988-90 as a result of the import substitution of food and the decline in defense-related imports. While the trade deficit narrows over the program period, the current account deficit narrows more sharply (from about 8 to about 6 percent of GDP; Table 2), reflecting the anticipated rebound of tourism.

49. The external financing requirement over the program period is projected to decline from about SDR 775 million in 1988 to under SDR 550 million in 1990 (Table 3). More than half of the financing requirement is expected to be met by disbursements from the existing pipeline. Beyond this, the financing requirement is expected to be met through: (i) special grant and concessional financing for the reconstruction program expected to average about SDR 80 million annually; (ii) disbursements out of likely new commitments from the Aid Group; and (iii) Fund financing under the structural adjustment facility and, in 1988, through a purchase under the compensatory financing facility.

50. Assuming the financing requirement is met in this manner, gross official reserves would rise gradually to the equivalent of 2 months of (current year) imports and the debt profile will remain manageable because there is no commercial element in the projected new financing. The debt service ratio (as a percentage of current account receipts) would decline from 23 percent in 1988 to 16 percent in 1990.

Table 1. Sri Lanka: Policy Matrix

Policy areas	Objectives	Strategies and measures	Timetable
1. Public sector policies			
a. Budget formulation	Direction of government policy.	- Establish medium-term budgetary framework.	1988*
		- Identify expenditure priorities and limits.	Each budget
b. Revenue	Ensure performance.	- Introduce revenue measures needed to meet fiscal objectives.	Each budget
	Improve efficiency.	- Income tax: simplify and reduce rate structure; reduce exemptions.	1988*
		- Abolish minor export taxes (see 3. below).	1988*
		- Reduce specific taxes on tea.	1988*
		- Shift specific excise taxes to ad valorem basis.	1988-90
		- Specific administrative reforms to improve BTT/excise tax collections.	1988
c. Expenditure	Strengthen expenditure control and monitoring.	- Eliminate carry over of unused appropriations through deposit accounts.	1988*
		- Adhere to budgetary limits on advance accounts.	Each year
		- Effective monthly reporting system, reconciliation of Treasury and monetary accounts, and improved monitoring of external financing/grants.	Each year
		- Agreement on limits to the use of supplementary appropriations.	Each year
	Reduce the share of public expenditures in GDP.	- Reduce transfers to corporations.	Each year
		- Reduce subsidies while improving their effectiveness.	1989-90
		- Reduce defense spending.	1988-89
		- Assisted by World Bank, establish expenditure priorities to accommodate reconstruction and development programs within expenditure targets.	Each year
	Civil service reform.	- Implement civil service reform recommended by Administrative Reforms Committee to reduce overstaffing and restructure salaries.	1988-90
		- Prepare a timetable for implementation of the recommendations of the Administrative Reforms Committee to reduce overstaffing.	1988
		- Continue freeze on filling of vacancies in Central Government while phasing in employment reforms.	1988-90
2. Monetary policy	Enhance market forces.	- Improve treasury bill auction: gradually remove Central Bank from tenders and raise penalty for rediscounting bills.	1988-89
		- Develop repurchase arrangements for open market operations.	1988
		- Market determined forward exchange rates.	1987*
		- Strengthen bank supervision, including of other financial institutions, through preparation of new legislation.	1988-89
	Reduce intermediation costs.	- Eliminate BTT on inter-bank transactions.	1989-90
		- Unify and reduce reserve requirements.	1987*
	Restructure financial institutions	- Program for restructuring nonbank financial institutions	1988-89

* Already implemented.

Table 1. Sri Lanka: Policy Matrix

Policy areas	Objectives	Strategies and measures	Timetable
3. External policies	Exchange rate policy.	- Flexible management to prevent real appreciation.	Each year
		- Restore official reserves to at least 2.0 months of projected imports.	1989-90
	Export promotion.	- Abolish export taxes on minor agricultural and marine exports.	1988*
		- Abolish most export licensing and prior approval procedures.	1988*
		- Liberalize gem industry.	1987*
		- Duty-free access to imported inputs and tax rebates for indirect exporters.	1988*
		- Reduce administrative impediments (Trade Facilitation Committee).	Each year
		- Review adequacy of export financing facilities; improve short-term financing.	1988
		- Abolish export floor price scheme and associated prior approval.	end 1987*
4. Sectoral policies			
a. Industry	Develop internationally competitive industrial sector.	- Implement recommendations of Industrial Policy Committee in areas of export promotion (discussed above), public enterprise reform, and tariff reform.	1988-90 #
		- Keep foreign and domestic investment procedures under review.	Each year
b. Tariff and licensing reform		- Announce phased program of tariff reform.	1988 Budget* #
		- Reduce maximum tariff rate to 60 percent and raise minimum to 5 percent.	End 1987* #
		- Introduce four-band tariff system and lower maximum tariff rate to 50 percent.	1988-89 #
		- Eliminate import licensing requirements for yarns and textiles and for textile and leather processing machinery.	End-1987*
		- Eliminate remaining import licensing requirements except for security, health, or environmental purposes.	1988-90
c. Public enterprises		- Announce objectives of privatization and phased program.	1988 Budget*
		- Divestiture of State Distilleries, United Motors, and Ceylon Oxygen.	1988
		- Entry of private enterprise into insurance and telecommunications sectors.	1988*
		- Phased program with annual targets for additional privatization of Government Business Undertakings.	Each year
		- Transform 16 selected public manufacturing enterprises into public liability companies.	1988
		- Establish and expand database for the financial accounts of the 12 most important public enterprises and extrabudgetary units.	Each year
		- Rehabilitation programs for indebted corporations—Air Lanka and Ceylon Shipping.	Each year
		- Effective monitoring of major extrabudgetary units/enterprises.	Each year
d. Agriculture	Strengthen traditional tree crop sector and promote agricultural diversification.	- Raise tea producers' margins through tax reductions.	1988* #
		- Rehabilitation of public and private tree crops.	1987-90* #
		- Reduce fertilizer subsidies.	1989-90
		- Formulate a strategy to increase the coverage of the agricultural credit system.	1988
		- Development of irrigation potential and improvement of cost recovery in irrigation.	1988-90 #
		- Eliminate public sector from import and domestic sugar trade.	1987*
e. Energy	Meet energy demand at least cost.	- Improve efficiency of existing systems.	1988-90 #
		- Realistic price policies.	Each year #
		- Institutional rationalization of the distribution function and improved management of billing and collection systems.	Each year

*Already implemented.
#Also supported by ongoing World Bank group operations.

Table 2. Sri Lanka: Key Indicators, 1984-90

	1984	1985	1986	1987	1988	1989	1990
GDP growth rate	5.1	5.0	4.3	3.0	5.5	4.5-5	4.5-5
GDY growth rate 1/	11.0	0.7	1.8	3.1	5.9	4.5-5	4.5-5
GDY/capita growth rate	9.2	-0.9	0.2	1.5	4.2	3.3	3.3
Consumption/capita growth rate	--	13.6	1.9	3.0	2.5	2.1	2.3
Inflation rate (average) 2/	16.6	1.5	8.0	8.5	7.5	6.0	5.0
Debt service (in US$ mn.)	309.5	346.1	422.6	535.6	549.7	528.0	462.3
Debt service/exports of goods and services	17.2	21.1	26.7	29.9	27.5	23.5	18.4
Debt service/GDP	5.1	5.8	6.6	7.8	7.7	7.0	5.7
Gross investment/GDP	25.8	23.8	23.7	22.0	23.0	23.0	23.0
Domestic savings/GDP	19.4	11.8	12.2	11.3	12.6	13.6	15.0
National savings/GDP	21.6	13.9	14.4	13.6	14.8	15.8	17.0
Marginal national savings rate	--	-140.1	26.0	-13.1	36.6	35.8	41.0
Public investment/GDP	12.4	12.3	13.7	12.8	13.7	12.7	11.3
Public savings/GDP	3.4	0.6	1.4	0.9	2.6	2.5	2.5
Private investment/GDP	13.4	11.6	10.0	9.1	9.3	10.3	11.7
Private savings/GDP	18.2	13.4	13.0	12.7	12.2	13.3	14.5
Ratio of public/private investment	0.9	1.1	1.4	1.4	1.5	1.2	1.0
Government revenues/GDP	22.2	22.3	20.8	20.8	20.4	20.5	20.5
Government expenditures/GDP	31.1	34.0	33.0	32.7	31.4	30.7	29.3
Deficit (-) or surplus (+)/GDP	-9.0	-11.7	-12.2	-11.9	-11.0	-10.2	-8.8
Domestic financing/GDP	2.6	5.3	5.1	5.6	3.8	2.9	2.6
Export growth rate (US$ nominal)	37.8	-10.1	-8.2	18.0	11.5	12.5	11.2
Exports/GDP	24.2	22.1	18.9	20.7	22.4	23.6	24.7
Import growth (US$ nominal)	0.5	5.7	-3.6	18.4	8.9	7.5	6.6
Imports/GDP	31.9	34.2	30.7	31.0	32.6	32.8	33.0
Current account (in US$ mn.)	-255.2	-590.7	-597.6	-575.9	-580.2	-546.7	-482.4
Current account/GDP	4.2	9.9	9.3	8.4	8.2	7.2	6.0

Sources: Based on data provided by the Sri Lankan authorities; and IMF and World Bank staff estimates.

1/ GNP adjusted for changes in purchasing power of exports in terms of imports.

2/ Colombo consumer price index.

Table 3. Sri Lanka: External Financing Requirements, 1987-90

(In millions of SDRs)

	1987	1988	1989	1990
Current account deficit, excluding official transfers	443	433	408	360
Amortization	200	205	200	167
Change in reserves (decline -)	-135	94	31	24
IMF repurchases	69	64	46	32
Less: Direct investment	19	22	30	40
Total financing requirement	558	774	656	543
Disbursements: existing commitments	554	520	404	337
Grants	149	103	83	74
Loans	269	298	242	191
Bilateral loans	146	180	133	120
Multilateral loans	123	118	109	71
Of which: World Bank	71	67	65	41
Other	136	119	80	72
Disbursements: expected new commitments	4	254	252	206
1. Reconstruction aid	4	77	97	65
Grants	1	24	51	34
Loans	3	53	46	31
Bilateral loans	3	17	8	6
Multilateral loans	--	36	38	25
Of which: World Bank	--	18	19	12
2. Development assistance	--	23	88	111
Grants	--	6	22	31
Loans	--	17	66	80
Bilateral loans	--	11	27	35
Multilateral loans	--	6	39	45
Of which: World Bank	--	3	24	38
3. IMF	--	154	67	30
SAF	--	45	67	30
CFF	--	109	--	--
Financing gap	--	--	--	--

Sources: Based on data provided by the Sri Lankan authorities; and IMF and World Bank staff estimates.