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Minutes of Executive Board Meeting 86/109

10:00 a.m., July 7, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	Mawakani Samba
C. H. Dallara	M. K. Bush
	M. Lundsager, Temporary
	L. K. Hubloue, Temporary
	T. Alhaimus
	M. B. Chatah, Temporary
	M. Sugita
	K. Murakami, Temporary
G. Grosche	
	Yang W., Temporary
J. E. Ismael	Jaafar A.
	J. Hospedales, Temporary
	S. King, Temporary
	R. Fox, Temporary
	I. Puro, Temporary
	O. S.-M. Bethel, Temporary
	W. N. Engert, Temporary
	S. M. Hassan, Temporary
	C. A. Salinas, Temporary
	J. E. Suraisry
	J. E. Rodríguez, Temporary
	S. de Forges
J. J. Polak	
C. R. Rye	A. V. Romuâldez
	A. A. Agah, Temporary
	A. S. Jayawardena
	V. Govindarajan, Temporary
	N. Kyriazidis

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

IBRD: A. C. Tsantis, Division Chief, South Asia Regional Office. African Department: A. D. Ouattara, Director; N. Abu-zobaa, R. T. Stillson. Asian Department: H. Neiss, Deputy Director; F. Le Gall, A. K. McGuirk, I. Otani, D. M. Ripley, D. J. Robinson, D. A. Scott. European Department: L. A. Whittome, Counsellor and Director; A. Mountford. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director. Legal Department: H. Elizalde, P. L. Francotte. Middle Eastern Department: S. Thayanithy. Bureau of Statistics: M. R. P. Salgado, N. Weber. Advisors to Executive Directors: W. R. Bengs, L. P. Ebrill, G. Nguyen, A. Vasudevan. Assistants to Executive Directors: J. R. N. Almeida, B. Bogdanovic, F. Di Mauro, G. K. Hodges, A. R. Ismael, T. Morita, V. Rousset, D. Saha, B. Tamami, H. van der Burg.

1. SEYCHELLES - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Seychelles (SM/86/129, 6/10/86). They also had before them a report on recent economic developments in Seychelles (SM/86/148, 6/26/86) and an information notice on the real effective exchange rate of the Seychelles rupee (EBS/86/135, 6/25/86).

Mr. Rye made the following statement:

> My Seychelles authorities consider that the staff report for the 1986 Article IV consultation provides a generally balanced assessment of economic trends and policy issues in Seychelles. They do, however, have reservations about some aspects of the assessment, and wish to comment on the substantive policy issues raised.
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> While fiscal policy remained expansionary in 1985 and contributed much to the strong noninflationary growth achieved during that year, my authorities recognize that the financing requirement of the 1985 budget contributed also to the pressures on the external accounts. In any case, the fiscal stimulus is likely to have been much less than is suggested by the change in the overall deficit between 1984 and 1985. Certain large outlays included in the 1985 budget (much larger than in the 1984 budget) did not result in a commensurate increase in domestic incomes or demand for local goods and services. For example, an amount of SR 70 million in respect of the costs of hotel purchases and parastatal debt refinancing (see footnote 2, Table 2 of the staff report) represents changes in the ownership of existing domestic assets and liabilities and would have had no direct effect on economic activity. More generally, much of the capital expenditure recorded in Seychelles' budgets is financed by offshore payments from a foreign lender to a foreign supplier, with little or no direct effect on domestic incomes and demand (debt-servicing costs apart).
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> In recognition of the need for fiscal restraint, the 1986 budget calls for a reduction in the government and public sector deficits, in absolute terms and in relation to GDP. My authorities consider that the staff's alternative 1986 budget projections underestimate both revenue and capital outlays and thus overestimate the deficit and the domestic financing requirement. Specifically, trade tax collections are projected to exceed the budget estimate, mainly because of lower landed prices of petroleum products, and capital expenditure on major projects to be financed by foreign loans is expected to continue at a high level during the rest of 1986.

The Government will soon be reviewing the execution of the 1986 budget in the light of recent economic and budgetary developments and will consider any necessary remedial action, guided by the need to constrain the growth of recurrent outlays, including transfers to the parastatal sector, and to improve the efficiency of public sector activities generally.

The Government agrees with the general thrust of the staff's comments on the need for improved financial performance by many parastatal enterprises. However, the combination of circumstances and policy objectives in the Seychelles parastatal sector is diverse and complex. As noted on page 10 of the staff report, some parastatals have purely social objectives which in most countries are pursued by government departments, while other noncommercial activities contribute significant external benefits to the commercial sector of the economy. The public utility enterprises and the Seychelles Marketing Board are required to pursue both social and commercial objectives. Establishment of an appropriate policy environment and of the necessary incentives for the economic and efficient operation of parastatals therefore needs to go beyond performance assessments and policy prescriptions based on purely commercial indicators. The Government intends to give urgent attention to the development of an appropriate policy framework for the parastatal sector, including identification of commercial and noncommercial objectives, criteria for evaluating the productive efficiency and financial performance of public enterprises with multiple objectives, and arrangements for monitoring and reviewing performance against those criteria.

The Government is very conscious of the immediate and prospective pressures on the balance of payments and foreign exchange reserves and is examining relief measures, including those suggested in the staff report. They are exploring sources of untied aid that might restore foreign exchange reserves to a level consistent with continuing foreign payments obligations and maintenance of confidence in the economy.

My authorities have noted the comments in the staff report on the possible advantages of a more flexible exchange rate policy and intend to study these suggestions in their examination of measures to relieve the pressures on the balance of payments. They remain concerned, however, that a more flexible exchange rate policy for the Seychelles may not be very effective. Tourism accounts for 80 percent of Seychelles' foreign exchange earnings, and air fares (much of the cost of a holiday in Seychelles) are paid for in foreign currency and would therefore be unaffected by a depreciation. The very substantial imported component of domestic tourist expenditure would be adversely affected. It is questionable whether a more flexible exchange rate policy would offer significant competitive benefits for export- and import-competing industries given the price inelasticity of Seychelles exports and the high import content of locally produced goods.

The Government's investment in capital projects and certain net lending to, and foreign borrowing by, the parastatal sector for capital purposes are central elements in the longer-term strategy of promoting economic growth. While this strategy has contributed to short- and medium-term economic pressures, the Government believes that failure to diversify and strengthen the Seychelles economy would result in potentially more serious longer-term imbalances.

At the same time the rate of implementation of development projects will continue to be determined having regard to the short- and medium-term constraints imposed by the macroeconomy, with priority for projects which offer longer-term contributions to foreign exchange earnings and economic growth and that can be financed on concessional terms. The Government recognizes, in this context, the need for close monitoring of the foreign debt position and for paying regard to the impact of debt-servicing costs on the external accounts in the years ahead.

Mr. King remarked that 1985 appeared to have been a relatively sucessful year for the Seychelles economy, due in no small part to the further substantial increase in activity in the tourist and fishing industries. Reflecting those favorable developments, real GDP was estimated to have risen by about 6 percent, while inflation had fallen to below 1 percent. Despite the apparent healthy picture of the economy, some imbalances had continued to grow. And, as the authorities themselves apparently recognized, those imbalances seemed to pose a threat to the objective of steady growth.

The Seychelles economy remained an open one, Mr. King continued, with the level of imports equal to approximately 80 percent of GDP and with some 80 percent of export earnings deriving from tourism alone. In light of that dependence, the rise in the value of external debt by a factor of 4.5 in nominal terms between 1980 and 1985 must be a source of concern, as it could serve only to increase the vulnerability of the economy to adverse external developments. It was thus appropriate that the authorities recognized the need to closely monitor the foreign debt position in the years ahead.

The staff's medium-term scenario for Seychelles appeared if anything to be based on rather optimistic assumptions, Mr. King commented. Even so, it showed the importance of closely monitoring the external position. The heavy dependence upon tourism meant that even small changes relating to the projections for the outlook for that industry could lead to a rise in unsustainable financing gaps. In light of those uncertainties, some increase in the stock of reserves from the present low level would seem to be desirable.

In seeking to improve the external position, the authorities should carefully monitor wage and exchange rate policies to ensure that the tourist industry in particular remained adequately competitive, Mr. King continued. He had noted from Mr. Rye's statement that the authorities harbored some doubts about the efficacy of the exchange rate in that regard, and they would presumably thus prefer to place greater emphasis upon wage policy. In any event, the statistical table on page 58 of SM/86/148, which compared the relative cost of tourist packages in Seychelles with those in some of its major competitors, showed that for Seychelles in 1985, some three quarters of the market sectors considered in the table had risen, which seemed to indicate that the competitiveness of the tourist industry had fallen and highlighted the need for vigilance by the authorities on the exchange rate and wage fronts.

The strains upon the external position in recent years were themselves partly a reflection of the need to finance the growing budget deficit, which even after grants had risen from 6.5 percent of GDP in 1980 to nearly 18 percent in 1985, Mr. King said. While the authorities apparently believed that the deficit thus defined was not a perfect measure of the Government's calls upon domestic resources--an observation confirmed by the low level of wage and price pressures-deficits of such a magnitude must naturally add to the pressures on the external sector if they were not to absorb an excessive amount of private sector savings. It was thus appropriate that the latest budget called for a reduction in the overall deficit.

The deterioration in the finances of the public sector in recent years was partly a response to the rapid expansion in the size and scope of the public enterprises over the same period, Mr. King noted. In general, he shared the staff's concerns about the need to ensure that the parastatal enterprises were efficiently operated and did not become an excessive burden upon the budget. It should perhaps be noted that transfers and loans to the parastatals had amounted to 25 percent of total government outlays in 1985. On more specific aspects of the parastatals, he noted, first, that the Seychelles Marketing Board had been established because the authorities were concerned that a small number of commercial traders had been manipulating the relatively small domestic market to gain excessive profits. While he could understand why the authorities might wish to encourage greater competition in that area by establishing the Seychelles Marketing Board, he was less certain why they intended to give the Board a monopoly over the pricing of domestic and imported commodities. Allowing the Seychelles Marketing Board and the traders to compete equally might have been a way of ensuring that prices did not get out of line.

Second, taking note of the view of the authorities that the state utility companies operated on the basis of both social and commercial objectives, Mr. King wondered whether the staff had any specific information on the financial performance of the public utilities and on the cost of meeting their implicit social objectives. More generally, since the authorities believed that where the parastatals were mainly commercial they should pay dividends to the authorities, he would be interested in knowing whether the authorities had given any thought to setting quantitative indicators of the desired level for such flows, possibly in the form of targets for the rate of return on the capital of those enterprises.

Ms. Lundsager remarked that the staff report and Mr. Rye's statement painted a rather mixed picture of economic performance in Seychelles during 1985. A number of favorable trends had emerged, including a reduction in inflation and a resumption of strong growth, following the recession earlier in the decade. Nonetheless, those outcomes masked some deeply rooted trends that could, in the relatively near future, lead to serious external financial problems. The continued weak performance of the public enterprise sector was one of the major problems facing the authorities, and it was uncertain that sufficient progress was being made in containing the financial drain on the budget created by those enterprises. While it might well be that those entities had been created to serve social goals, economic constraints could ultimately undermine the ability of the authorities to meet those goals. Hence, she recommended a reduced role for the Government in providing goods and services that could be privately produced. She understood the authorities' concern that monopolistic practices among suppliers could lead to monopolistic prices. However, as she saw it, stronger efforts to maintain a competitive market could be far more effective in providing a long-run stable supply to the domestic population. As things stood at present, a parastatal entity could find it difficult to change administered prices as necessary, and might become dependent upon government transfers. Were the budgetary situation to become unsustainable, those entities might be unable to supply domestic markets with needed goods. While that might be an extreme example, it had become clear from experience in a number of countries that the Government could not provide all desired goods and services to the population if the total exceeded the resources available to the country.

The medium-term scenario on page 15 of the staff report indicated that the resource limitations she had described might, in fact, be confronted during 1986, Ms. Lundsager continued. Notably, the projected financing gap for 1986 was equal to more than half the level of "other official transfers." The increase would seem to demand a large rise in external support from donors, and it would be unfortunate if borrowing on commercial terms--with its obvious adverse impact on the future debt-servicing burden--were to be relied upon to provide a temporary solution.

It would appear that an increase in official reserves was desirable, particularly given the current low level of reserves and the high dependence of the Seychelles economy on imports, Ms. Lundsager observed. Mr. Rye had implied that, since the supply of exportables and demand for imports in Seychelles were price inelastic, a devaluation would not improve the current account to any noticeable degree. While that might be true in the short run, elasticities tended to be higher in the longer term; in fact, very low elasticities sometimes implied that quite substantial exchange rate adjustments were called for to restore equilibrium. The point to be made was that the balance of payments table seemed to indicate the emergence of a sizable disequilibrium requiring a short-run correction that could lead to a longer-run return to a sustainable trend, a goal that could perhaps be served by exchange rate action. She noted that the authorities were keeping exchange rate matters under active consideration, and she urged them not to postpone action for so long that very large corrections might then be required. Of course, any exchange rate action would need to be supported by much more restrained fiscal and monetary policies, a goal toward which the authorities had already taken some welcome steps, including the limitation on wages, which could have an important impact on international competitiveness. However, the overall deficit seemed to be unsustainable at present levels, in the absence of large increases in external debt, a development that the authorities apparently wished to avoid. She would therefore urge much stronger action on the expenditure and net lending side and improved performance of the public enterprise sector.

In conclusion, Ms. Lundsager said, the Seychelles authorities had little time for study and evaluation of alternative courses of action. Steps should be taken immediately to improve the prospects for 1986 and the remainder of the decade. She welcomed the indication by Mr. Rye that the Seychelles authorities were about to undertake a midyear budget review and that they would take any remedial action deemed necessary; she hoped to see a much improved fiscal situation as a result of that review.

Mr. Mawakani said that his chair was in general agreement with the staff's appraisal of the Seychelles economy. Clearly, the 1984 economic upturn had strengthened in 1985: inflationary pressures had diminished considerably, and the overall balance of payments deficit had narrowed somewhat. Concomitantly, performance had been unsatisfactory in other areas. The overall fiscal deficit had widened substantially; credit to the Government had risen sharply while the downward trend of private sector credit had continued; the reserve position of the country had weakened; and debt service had continued to advance significantly. Taken together, those elements added up to a perceptible deterioration in the financial situation of the Seychelles in 1985.

The overall deficit of the Central Government, after grants, had widened substantially to reach approximately 18 percent of the total output of the country in 1985, Mr. Mawakani continued. While that trend was the result of large public investments in areas of particular importance to Seychelles--namely, tourism and transportation--it had led to imbalances that were clearly unsustainable in the longer run. For 1986, the fiscal deficit was forecast to remain large. It was thus encouraging to note that the authorities recognized the precariousness of the financial situation of the country, especially in the budgetary area. Their efforts to raise revenue by renegotiating fishing contracts with foreign operators and consolidating some taxes could be helpful; however, in light of the limited potential for rapid revenue growth in the medium term, emphasis should be placed on restraining expenditure. In that context, he welcomed the Government's efforts to improve the efficiency of some public sector enterprises. Further measures that would improve the financial situation of those enterprises and thus reduce the need for government transfers and reliance on bank credit should be actively examined. Also, the authorities should make an effort to improve the monitoring and control of government outlays.

He noted with some concern that the external debt of the Government had more than quadrupled since 1980 to SDR 77 million in 1985, Mr. Mawakani commented. Even more worrisome was the sharp rise in the debt service obligations from 0.3 percent in 1980 to approximately 11 percent five years later. While at 11 percent the debt service ratio might appear small by comparison with that in other countries, the authorities should be urged to formulate and implement a more prudent debt policy to avoid a debt profile that might not be correctible. The rapidly rising debt service obligations clearly underscored the need to ensure profitability of the public sector enterprises, particularly those that were the beneficiaries of foreign loans contracted by the Government. Emphasis should be placed on financing new investments with foreign grants and concessional loans.

In sum, Mr. Mawakani said, while there had been a strong expansion of economic activity and a noticeable deceleration of inflation in 1985, the financial situation of the Seychelles had deteriorated substantially. Economic and financial prospects were likely to be dim, in the absence of the implementation of firm adjustment measures and enhanced economic management. In the circumstances, the authorities should re-examine their policies--particularly budget and investment policies--to reduce over time the mounting financial pressures in the economy.

Mr. Govindarajan observed that Seychelles was a small, open economy that had been hard hit by recession in the period 1980-83, when its real GDP had fallen by more than 12 percent despite the fact that the authorities had been following a comparatively expansionary stance. During the period, the authorities had begun acquiring hotel and other tourist facilities and had established an international airline, Air Seychelles. Simultaneously, a large number of other parastatals had been created to provide the necessary stimulus to the economy at a time when the private sector had been withdrawing or had been unwilling to enter into some areas. Understandably, the nascent parastatals as a group had registered overall deficits in the initial period and had needed to be supported by government transfers, increases in bank credit, and external borrowing. It should perhaps be noted that inflation had been reduced from some 13.6 percent in 1980 to 4 percent in 1984, and 0.8 percent in 1985, which indicated that the expansionary stance of the budget had been matched by growth and had therefore remained noninflationary.

It would not be possible for Seychelles to continue along the path he had described without entering into large external borrowing and resulting debt service difficulties, Mr. Govindarajan continued. As noted by Mr. Rye, the authorities were apparently cognizant of the need for fiscal restraint and for improvement in the performance of the parastatals, toward which end the staff had made a number of suggestions. While he could agree with the general thrust of the staff argument that the public sector enterprises should be able to finance themselves through improvements in efficiency, it was difficult to accept the recommendation that the Government or the parastatals should give up activities that could not be made to break even in the short term. In many developing countries, the public sector often played a useful supporting role to private sector growth by initially taking on the necessary but relatively unattractive infrastructure activities and industries that aided in the overall development of the economy. In some cases, those public sector enterprises had become profitable over the longer run; while parastatals must of course aim at the highest levels of productivity, it was a rather different matter to state that they should go out of business simply on the grounds that they could not break even in the short term. Besides, as Mr. Rye had observed, "establishment of an appropriate policy environment and of the necessary incentives for the economic and efficient operation of parastatals needs to go beyond performance assessment and policy prescriptions based on purely commercial indicators."

It was heartening to note that the Government was aware of the problems and intended to give urgent attention to the development of an appropriate policy framework, Mr. Govindarajan concluded. However, he saw logic in the view of the authorities that a more flexible exchange rate policy might not necessarily offer significant competitive benefits for export and import-competing industries, given the price inelasticity of Seychelles exports and the high import content of locally produced goods.

The staff representative from the African Department remarked that, given the importance attached by Directors to the large fiscal deficit in 1985 and the specific reference by Mr. Rye to the purchase by the Government of two privately owned hotels and the takeover of certain liabilities of the Seychelles Commodity Corporation, it might be worth detailing further the difference of view between the staff and the Seychelles authorities regarding the impact on the government deficit--and its domestic and foreign financing--of those actions. The purchase by the Government of the two hotels had been financed by the former owners of the hotels, and the cash outflow from the Government had been limited to a relatively small downpayment; the Government recorded that outflow as the only effect of the transaction on the current year's budget. However, the staff felt that the transaction was no different from one where the Government paid for the hotels and financed the payment by foreign borrowing. Hence, the staff had added the cost of those hotels to the list of capital expenditures and foreign financing, thus increasing the deficit.

The other transaction had been the acceptance by the Government of the bank debt of the Seychelles Commodity Corporation when that Corporation had been disbanded and the Seychelles Marketing Board had been established in its place, the staff representative continued. The staff felt that the assumption of that debt was the equivalent of a grant to the parastatal, and thus a current expenditure financed by domestic bank credit. Because of the difficulty of consolidating all of the transactions of the Government and the parastatals--particularly the two large transactions he had mentioned--the staff's analysis and assessment had been based upon the public sector deficit and the expansion of credit to the public sector, including both the parastatals and the Government. Another reason for basing the assessment on the consolidation was that several parastatals had as their function what in other countries might be performed by government departments. Having no independent source of revenue, they had been called in the staff report the "budget dependent parastatals," one of four separate categories of parastatals. The others were the public utilities, the commercial parastatals, and the Seychelles Marketing Board.

The Seychelles Marketing Board held a monopoly over certain commercial activities in Seychelles, particularly the purchase from local producers of all fruits and vegetables and the purchase and distribution of imports and exports, the staff representative remarked. The Board had been allowed monopolistic control in Seychelles because, as he understood it, the authorities felt that the commercial activities could not be performed efficiently by a variety of competing companies, a view the staff did not fully share.

In response to questions on the exchange rate, the staff representative noted that the major exchange earning activity in Seychelles was tourism, a large component of which were airfares, which were inelastic in relation to the exchange rate. However, there was substantial domestic value in the sector, mainly the operation of hotels, foods, and subsidiary services, and any action on the exchange rate would be aimed at increasing the competitiveness of those services. Also, exchange rate action and an improvement in competitiveness would allow the loss-making parastatals to increase their domestic prices, which would increase domestic costs of the tourism and fishing industries, without forcing those industries to suffer a loss of international competitiveness. That way of exchange rate flexibility was particularly important because one aspect of improving the financial situation of the parastatal enterprises was through more flexible pricing policy, of which a flexible exchange rate policy was an integral part. Finally, with respect to the effort to encourage profitability among the parastatals, the authorities themselves felt that those enterprises competing with the private sector should have as an ultimate objective the achievement of a positive return on investment, a goal which the staff could support.

Mr. Rye noted that there was an ideological bent in Seychelles toward government activities. While that did not in the slightest detract from the high priority to be placed on ensuring the efficiency of the parastatals, it was a fact to be borne in mind in any review or assessment of bodies like the Seychelles Marketing Board. On other matters, he did not believe the authorities had ruled out the possibility of exchange rate action; indeed, they had indicated that they would be examining carefully the views and arguments of the staff on that issue. Despite some apparent skepticism by the authorities at present, he was certain that, in the end, a more flexible exchange rate policy would emerge.

The Acting Chairman made the following summing up:

Directors were in general agreement with the thrust of the staff appraisal in the report for the 1986 Article IV consultation with Seychelles. They welcomed the continued growth in economic activity and the decline in the inflation rate to a relatively low level in 1985. However, taking into account the openness of the economy and its dependence on tourism, they were concerned that the large budget deficit, the related rise in foreign debt, and the weakening of competitiveness might threaten the sustainability of this growth and the free exchange system.

Directors noted that the rapid growth in the Government's deficit was primarily due to the large transfers from the budget to the parastatal enterprises. While observing that certain parastatals are pursuing social rather than commercial objectives, they stressed the need to reduce the borrowing requirements of these enterprises and to impose stricter controls on Government expenditures. Directors were concerned that the 1986 budget did not sufficiently address these problems and that continued large transfers to parastatals were budgeted. The budget deficit for 1986, forecast to rise to the range of 16 percent of GDP, was regarded by Directors as unsustainable. Directors suggested that in order to reduce the budget deficit, the authorities should examine closely the operations of the enterprises with a view to increasing their efficiency, re-examining their investment programs, encouraging privatization of certain enterprises, and ensuring the maintenance of an open import system to strengthen competition with the existing firms.

Directors stressed the importance of wage restraint and of a flexible pricing policy to reduce public sector deficits while ensuring international competitiveness of tourism and other industries. In that regard, Directors strongly welcomed the authorities' indication that they would keep under close review the appropriateness of the present exchange rate regime, which had led to a real effective appreciation in the exchange rate over the period 1980-85. In addition, they urged the Seychelles authorities to exercise greater caution in contracting foreign debt, particularly on commercial terms, and to give high priority to a strengthening of official foreign reserves. In that connection, the rapid increase in foreign financing underscored the importance of addressing the problem of the fiscal deficit.

Directors welcomed the authorities' maintenance of a completely free exchange system and their realization that such a system is vital to the achievement of Seychelles' medium-term objectives.

It is expected that the next Article IV consultation with Seychelles will take place on the standard 12-month cycle.

2. SINGAPORE - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Singapore (SM/86/132, 6/12/86). They also had before them a report on recent economic developments in Singapore (SM/86/144, 6/25/86).

Mr. Jaafar made the following statement:

My authorities wish to thank the staff for these excellent reports. They reflected the discussion that took place in Singapore in early April this year in connection with the Fund's Article IV consultation. My authorities consider the review of the Singapore economy for 1985 and the current year as important because it follows on the more comprehensive one just released in February 1986 by the Singapore Economic Committee (SEC). The staff shares in large part the same concerns expressed by the SEC. It is noteworthy perhaps to observe that much of the package of measures taken by the Government in both 1985 and 1986 are endorsed as appropriate by the staff as indicted in the staff appraisal.

The downturn in economic activity in 1985 ws indeed unprecedented. It came after 20 years of extraordinary performances, with real growth averaging close to 10 percent per year. The sharp decline in 1985 was more than a cyclical downturn. The problems were much more deep-seated and structural in nature. To be sure, external factors were partly to be blamed for the weak performance in exports; but according to the SEC report, the problem also lies closer to home in the domestic economy.

The loss of external competitiveness was a primary factor that had led to a weakening in investment activity. This is mainly related to the sharp rise in the unit labor costs over the last five years, since the introduction of the wage correction policy in 1979. Since then, labor costs have increased by as much as 90 percent, compared with a productivity increase of less than 35 percent. A second factor was the structural change in certain key industries, in particular, petroleum refineries, oil rigs, and shipbuilding, and repairs. These changes were brought about by an alteration in global demand and supply condition, associated in large part with the weak international oil market. The final factor was the weakness in domestic demand stemming largely from the slump in the construction sector.

The prospective weakening in Singapore's economic performance could already be seen as early as the period 1980-82, with the onset of the global recession; but they were clouded then by the impressive performance of the economy, especially by the exceptionally strong growth in construction, mainly because of the accelerated public housing program and the buoyant property market. When it emerged in 1985, the fall in construction activity, both in the public and private sectors, contributed a significant 1 percentage point to the decline of 2 percent in real GDP in that year.

The SEC's recommendations to bring about adjustments and structural changes were largely reflected in the policy packages and measures taken by the Government in 1985 and 1986.

For FY 1985, the medium-term expenditure measures and other revenue concessions had led, for the first time, to a realized deficit in the budget by as much as S$1/4 billion or equivalent to 3/4 percent of GDP. A similar stance of policy can be observed in the fiscal package for the current FY 1986. In that year, the deficit is projected to widen significantly to 6 1/2 percent of GDP, with an acceleration in public sector spending of close to 30 percent. These deficits will be completely financed from internal sources, with a drawdown in reserves, and domestic borrowings mainly from Pension Fund (CPF) savings. The authorities are not contemplating external financing; and in any case, it remains their long-term objective to maintain a balanced budget.

Such measures to increase government expenditure should be viewed within the context of the economic prospects for 1986 and 1987 and the medium term. The forecast is for growth during the next two years (1986-87) to remain subdued, with perhaps a further decline in output, before a resumption of a moderate growth rate of about 4-5 percentage points by 1988-89. The underlying causes for the subdued performances in the near term include the expected overhang in construction and a continued weakness in the exports of the petroleum and marine-related industries. The policy to contain wages, at least over the two years, will also contribute to the restraint of domestic demand. It is important, therefore, to view the acceleration in public sector spending, and especially investment, within that context, i.e., in support of growth. It is, of course, recognized that the need for government investment is now becoming more limited, with the near completion of the housing program and the already adequate supply of infrastructural facilities. Therefore, despite the projected rise in the ratio of overall government expenditure to GDP to as much as 50 percent of GDP this year, this ratio can be expected to decline significantly over the medium term. The action to revive the private sector could also be seen in the FY 1986 budget, and other measures previously introduced. Much of these were in line with the comprehensive recommendations in the report of the SEC to the Government.

Within a longer-term context, the policies taken in 1985 and 1986 reflected in part the Government's effort to restore the external competitiveness of Singapore vis-à-vis its major competitors. The policy package was impressive. The Government's recommendation to the National Wage Council (NWC) to moderate wages in 1985 to 3-7 percent, and followed by a wage restraining policy of no increase in wages over the next two years, has led to a substantial cut in unit labor costs. These are on top of the major tax concessions already made to both the individual and corporate sectors, and in addition to the substantial cut in the employer's contribution to the CPF from 25 percent to 15 percent. It is important to note that the measures were taken at a time when inflation was low, and the exchange rate was making a significant correction. Over the last 15 months to March 1986, it declined in nominal effective terms by about 18 percent.

Taking these adjustments into account--the wage freeze, the CPF adjustment, the corporate tax concessions, and the substantial depreciation of the Singapore dollar--it is estimated that as much as a 25 percent reduction in unit labor costs could be realized between 1985 and end-1987.

Monetary policy in Singapore has always been used to support the stability of the exchange rate, consistent with a noninflationary environment. This policy remains in place within the current year. The growth of domestic credit has been dampened by the weakness in investment activity. On the other hand, the decline in domestic interest rates has been more a reflection of the decline in such rates internationally. But it can also be seen that these rates are high in real terms, and therefore, giving rise to the possibility for some reduction in rates in support of growth, with a minimal of risk in rekindling inflation.

In summary, the period 1985-86 marks a significant pause in the extraordinary performance of the Singapore economy over the last 20 years. Looking at it from another perspective, this pause provides the necessary opportunity for the authorities to critically re-evaluate policies that were considered appropriate during the initial phase of its development. The economy is now projected to enter into another phase, with growth expected to be more subdued, but nonetheless, still high by international standards. During this time, the current account of the balance of payments will also be in surplus--a reversal from the traditional deficits observed prior to 1985. The renewed emphasis placed now on the market and on private sector initiative, with the Government playing a more indirect regulatory role, will put it in good stead for the coming decade; and the findings and recommendations of the SEC, which have been largely adopted by the Government, were illustrative of the kind of flexibility and pragmatism with which the authorities address economic policymaking.

Mr. Murakami remarked that for more than 20 years since Singapore's independence, the Singapore economy had enjoyed rapid economic growth, price stability, and a strong external position, owing mainly to the authorities' prudent financial management and their pursuit of an export-oriented open economy. In 1985, however, the economy had experienced a downturn, and real GDP had fallen by nearly 2 percentage points. While the weakness had been caused by a combination of various factors, the key component in the downturn had been gross fixed investment, which had fallen by 13 percent in real terms between 1984 and 1985, mainly reflecting a sharp fall in construction with the completion of major projects as well as a weakness in investment in export-oriented manufacturing industries as export performance had deteriorated.

The authorities had responded quickly to the adverse developments and had announced, in the spring of 1986, a comprehensive policy package aimed at strengthening the economy, Mr. Murakami continued. The strategy underlying the policy package was based on an improvement in competitiveness through a reduction in business costs and a strengthening of the role of the private sector through increased efficiency in business. Public sector development expenditure would also be accelerated and expanded under the plan.

Perhaps the most important and impressive part of the policy package was the containment of labor costs, Mr. Murakami went on. The authorities' wage policy took a two-pronged approach, which included severe wage restraint for the next two years followed by a more flexible policy with nominal increases in compensation to be limited to productivity growth over the medium term.

Some tax relief measures had been adopted in the middle of FY 1985/86 to counter weakening economic activity; and because of those measures, the 1985/86 budget had registered a deficit for the first time, Mr. Murakami commented. The 1986/87 budget was designed to reduce business costs by introducing additional tax reductions and to stimulate the economy through increased development expenditure. The budget envisaged a deficit of 8.4 percent of GDP, although that might be slightly overestimated. Against the background of severe recession and accumulated budgetary surpluses in the past, the fiscal policy for 1986 seemed to be appropriate, although a number of questions could be raised with respect to later years. First, it was worth asking whether the budget deficit should, at least in part, be financed by government bonds rather than drawings on reserves if the deficit was expected to be more than a temporary phenomenon. Second, he questioned whether there was a need to reassess the priorities of public investment as major projects were completed and, third, whether there was a greater role that indirect taxes could play in the tax structure. He would appreciate staff comment on those matters. In any event, the authorities should be commended for their commitment to balancing the budget over the medium term and to reducing the share of government expenditures in GDP.

The nominal exchange rate had been relatively stable vis-à-vis the U.S. dollar since the previous consultation, although in nominal effective terms, the Singapore dollar had depreciated by some 18 percent in the 15 months to March 1986, reflecting the depreciation of the U.S. dollar, Mr. Murakami remarked. While the authorities' major objective for exchange rate policy remained to moderate imported inflation and to maintain confidence in the currency, the depreciation of the exchange rate in effective terms could be said to have supported the adjustment effort. For the future, given the uncertainties regarding developments in the external value of the U.S. dollar, the role of the exchange rate in the adjustment process should not be dismissed out of hand.

The scope for monetary policy in Singapore had been limited because of the priority given to exchange rate policy, Mr. Murakami noted. However, as the operation of the public sector was expected to absorb less from domestic liquidity, and the current account was expected to register its first surplus in 1986, circumstances surrounding monetary policy were changing, and it was appropriate that the Government was moving toward a further development of domestic financial markets and conducting a review of monetary instruments. Thus far, there had been no firm signs of economic recovery in 1986; indeed, the authorities currently foresaw a second year of declining real GDP. However, assuming that the adjustment measures would take place broadly as planned, the medium-term staff projections seemed promising, with 4-5 percent real growth foreseen during the 1988-89 period.

Mr. Fox agreed with the staff and Mr. Jaafar that recent developments marked something of a watershed in Singapore's economic development. In addition to the structural problems associated with the long-term absolute and relative decline of some sectors, caused mainly by shifting comparative advantage, a sharp fall in private construction activity--reflecting overconstruction in the past--and the recent weakness of exports imposed additional adjustment burdens on the economy. The authorities' response to those developments had been broadly appropriate, and they were to be commended for the speed with which they had taken firm and wide-ranging adjustment measures. Prospects for reversing the decline in competitiveness that had gathered pace in the early 1980s seemed fairly good, since a large part of the trend reflected nonwage costs imposed by the Government that were, in principle, reversible. The staff's calculations pointed to a fall by 25 percent in relative unit labor costs by end-1987, assuming the full implementation of the authorities' policies, including severe restraint on direct wage costs. While those projections were encouraging, he agreed with the staff that the authorities should be prepared to use the exchange rate more actively to achieve their goals if wage restraint proved more difficult to achieve than the authorities were currently assuming, especially given the outlook for fairly minimal inflation.

However, a number of Singapore's problems were more structural in nature and would take longer to remedy, Mr. Fox considered. That was particularly true of the effort to promote private access to domestic savings. Action was necessary to reduce the dependence of industry on foreign savings and to assist Singapore's transformation into an international services center. On that latter point, he would have welcomed a more detailed assessment of whether the authorities' various policies would encourage growth in the services sector. He agreed with the authorities that direct investment in that sector would be beneficial. Recent improvements in the regulatory environment would also be helpful. On the other hand, he could support the staff's view that the tax incentives for savings in the Central Provident Fund and the Post Office Savings Bank must inevitably deter investment of funds elsewhere, notably in private sector securities, thus constraining the raising of domestic equity capital for new industries and hampering the development of a securities market, which the authorities had been hoping to encourage. While the Government's own borrowing needs were increasing, due to the emergence of government budget deficits, the authorities apparently did not expect private investment to be crowded out, since the government deficits would be financed largely from funds that would otherwise have been invested abroad. However, he would have welcomed somewhat more discussion in the staff paper of the implications of continuing budget deficits and their financing for, inter alia, the cost of funding, which might well tend to increase, particularly when the cut in contributions to the Central Provident Fund was taken into account. More generally, he agreed with the staff that the conjunction of government deficits and current surpluses and the associated reduced capital inflows would have significant consequences for monetary policy, and he endorsed the staff's recommendation for a thorough review of the instruments of monetary control.

On fiscal policy, Mr. Fox said that he would welcome clarification from the staff of the authorities' underlying policy stance. In 1985/86, the authorities had maintained that the budget had not been anticyclical, and the staff had agreed that cyclical factors had been an important reason for the emergence of the budget deficit. However, the Economic Committee had suggested that the significant withdrawal of domestic demand by the public sector had been a major factor contributing to the recent downturn. He would welcome comment on that apparent difference of view. He was also unclear about the 1986/87 position. Cyclical factors would certainly be at work, and statistical problems would be encountered, owing to the inclusion of large government subsidies to the Housing Development Board for the first time. At the same time, discretionary changes in fiscal policy would be made, and he would be interested in hearing what the discretionary fiscal impulse was likely to be in 1986/87. He was somewhat concerned in that regard at the very large increase in both current and capital spending in prospect for 1986, which would not only contribute to a large increase in the public sector deficit but would also go against the recommendation of the Economic Committee to reduce the role of the public sector. On that latter point, he noted that the Economic Committee had also recommended sales of shares in public sector enterprises, but the authorities did not intend to move rapidly toward that end, arguing that they did not need the money and did not wish to compete for capital with the private sector. Those arguments seemed to miss a key point, namely, that privatization of public enterprises might be helpful in increasing their efficiency and in promoting competition in the economy in general. He urged the authorities to reconsider their approach to that issue.

The staff report was full of examples of insufficiently comprehensive statistics hampering the analysis of economic developments in Singapore, Mr. Fox said. In particular, he had noted the lack of a breakdown in the balance of payments of "other services net," which included a number of important economic activities such as ship repair, oil refining, service income, and some interregional trade. He had also taken note of the discrepancy between budget and national accounts figures for current expenditures--which the staff had not been able to reconcile--and the lack of information on external debt of the nonmonetary private sector. He urged the authorities to improve the quality of data in all those areas.

On trade policy, the Singapore authorities had been the first to acknowledge that their economic success would not have been possible in a restricted trade environment, Mr. Fox remarked. Given growing protectionist tendencies abroad, the decision of the Singapore authorities not to restrict imports into Singapore was encouraging. The international trading environment was likely to continue to be difficult, and at some stage the authorities must face the problems that would be caused by the ending of Singapore's status under the generalized system of preferences. He urged the authorities to maintain their liberal approach to imports and to adopt a similarly positive attitude in other areas where international economic cooperation was important with a view to playing a fuller and more appropriate role in the international financial community.

Ms. Bush remarked that Singapore appeared to be carrying on its record of good economic management, including a responsiveness to changing economic circumstances. She was impressed by the promptness and comprehensiveness of policy changes characterizing the reaction of the Singapore authorities to changing conditions. In particular, as the rapid growth of the construction sectors--both private residential and nonresidential--and government infrastructure and public housing construction wound down, the authorities were re-emphasizing private sector growth, which meant that some recovery in after-tax profits was needed to foster investment in those areas. The rapid rise in unit labor costs and in relative unit labor costs through 1984 had not been tolerable, and the reversal of the trend in 1985 and in 1986 took on considerable importance. Similarly, the containment of other business costs such as interest rates and taxes had contributed to the achievement of the authorities' goals. The past pattern of public savings and investment flows no longer seemed well adapted to the task of facilitating private sector growth; in particular, there seemed to be a need for more efficient intermediation of private savings into private investment, which would introduce an expanded savings and investment channel to complement or replace the existing intermediation role that the Government had played through the recycling of budget surpluses back into the economy. It seemed that, as investment in construction wound down, and as reduced costs of doing business in industrial sectors took hold, more domestic investment in the industrial sector should take place. The reduction in the labor element of business costs had already begun, with a decline in the rate of increases in the nominal wages in 1985 to 6.5 percent, compared with a range of 9-15 percent in the previous five years.

A reduction in employer contributions to the Central Provident Fund and to the Skills Development Fund and a series of tax cuts beginning with the 1985/86 budget had also contributed to a restoration of after-tax profits, Ms. Bush continued. In fact, the array of fiscal measures—including accelerated depreciation, the 2 percent payroll tax, the corporate income tax rate, utility taxes that were applicable in the business sector, measures involving personal income tax rates, the property tax rebate, and education deductions in favor of the household sector--made an impressive list of tax measures that should contribute to the authorities' objective of stimulating activity in the private sector.

Given the probable need for new financial channels to mobilize and allocate domestic savings and investment, some regulatory reforms--such as those planned for the securities industry and future trading--might be needed to strengthen confidence in Singapore's financial markets, Ms. Bush commented. She welcomed the review to be conducted of the adequacy of traditional monetary tools, as well as the authorities' intention to develop a government securities market and to establish a nonlisted stock market.

With regard to the external accounts, Ms. Bush considered that the strengthening in the current account balance between 1980 and 1986 in the face of steadily rising relative unit labor costs was interesting. The rapid increase in exports to the United States seemed to explain much of those gains, as exports to the United States had accounted for more than 60 percent of the rise in total exports between 1980 and 1985. Those exports had, in turn, been related to direct investment in Singapore by multinational corporations; and Singapore was a good example of the very positive benefits of direct investment. On other aspects of the external situation, she had read with interest the section in the staff appraisal on exchange rate policy. It was clear that wage developments in Singapore had not recently been fully consistent with wage developments in competitor countries. However, with the recent decline in the Singapore dollar and the wage restraint that the authorities intended to exercise, some competitiveness should be restored. Still, it was not clear from the suggestion in the staff appraisal that the authorities intended further to reduce unit labor costs what policy the authorities were following with respect to the real effective exchange rate. It seemed as if the real effective exchange rate would fall substantially over the next one and a half to two years as wages were further restrained. She would appreciate comment from the staff on whether or not the focus on the nominal effective exchange rate by the authorities was the most appropriate method for viewing the exchange rate. In conclusion, the shift in Singapore's fortunes since the previous consultation had been dramatic. The response by the authorities to that shift had been equally dramatic. Substantial structural change might lie ahead, but she had confidence that the authorities would show prudence and determination in facing that challenge, as they had in the past.

Mr. Rye considered that the use by the staff of the word "watershed" to describe the Singapore economy was well chosen, as it referred to a place where one entered a new landscape. As the Singapore Economic Committee had concluded, "with the maturing of the economy and less bouyant external demand, Singapore's potential rate of growth has been reduced significantly." Two factors had been cited by the Singapore Economic Committee for the lower growth prospects: first, the maturing of the economy, a development that was expected to produce effects only slowly; and, second, adverse external demand, which had been less than buoyant for some time. Those factors did not account, except in a marginal sense, for the short-term difficulties confronting the Singapore authorities at present. Mr. Jaafar had lucidly explained those problems, central to which were the cumulative effects of the wage correction policy adopted in 1979. While it might be going too far to say that that policy had been a failure, it was certainly clear that the benefits bought with that policy had been purchased only at very high cost.

Given appropriate policies, Mr. Rye continued, he saw no reason why Singapore's present difficulties should not be overcome and the target of a 4-6 percent rate of growth for the future should not be attained. Some of those policies must be aimed at enhancing the role of the private sector and, more specifically, at the revival of private investment. As Chart 4 in the staff paper showed, public investment, which had been growing, was nearly equal to private investment, which had been shrinking; that relationship was inappropriate in Singapore's circumstances. In that respect, he shared the concerns voiced by some earlier speakers about the high level of public sector investment. In general, of course, the Government seemed to be aware of what needed to be done and intended to live up to its record of sound and flexible policymaking by adopting the necessary changes. Since he could fully endorse the thrust of those proposed changes, he had little to say other than to remind the authorities that wage restraint would be particularly important in the months ahead.

He had the impression from the staff appraisal that the staff was also satisfied with the authorities' approach, Mr. Rye commented. The only difference between his approach and that of the staff was that he would prefer more forthrightness on the matter of the exchange rate. Tourism and retailing, and the related construction activities, had been important to Singapore's prosperity. If that prosperity was to be maintained, the exchange rate must remain regionally as well as globally competitive. Finally, he had confidence that the authorities were appropriately tackling the current difficulties experienced by the Singapore economy.

Mr. Bethel observed from the staff report that Singapore was at a crossroads of its economic development and that the policies the authorities chose to implement would determine whether Singapore regained the pace of advance registered over the past 20 years. In that respect, he commended both the Singapore Economic Committee and the authorities for their pragmatic approach to the problems facing the economy.

In present circumstances, a period of restraint in public expenditure was appropriate, especially as adequate infrastructural activities were already in place or near completion, Mr. Bethel continued. The required impetus for continued growth must be sought from the private sector, and the implementation of suitable incentives to encourage its participation must be pursued. However, the extent of the incentives should be moderated by the authorities' revenue requirements, in light of the increased medium-term expenditures after 1989 envisaged by the authorities and the staff as necessary to support the level of growth. Also, Mr. Murakami's concern about a potential structural problem with respect to the deficit was shared by his chair. The need for moderation was reinforced by the authorities' decision to deal with the immediate problem of financing the budget deficit by tapping the resources of the Monetary Authority of Singapore and the Central Provident Fund, thereby risking the financial security of the latter. In that regard, the authorities must aim at again increasing the public savings, which had fallen by 20 percent in the past year. It should be further noted that 50 percent of tax revenue had been drawn from one source of incomes and profits, and it should be possible, on the basis of a review of the tax system, to produce other means of increasing revenue and savings.

While appreciative of the constraints on the authorities in their pursuit of noninflationary economic growth in an open economy such as that of Singapore, Mr. Bethel considered that the authorities should keep exchange rate policy under review, as a depreciation could be effective in achieving the competitive edge that Singapore required. He had taken note of the depreciation of the Singapore dollar by some 18 percent in nominal effective terms over the past year. The action plan of the authorities to encourage financial institutions to implement an interest rate policy conducive to both growth and savings, and the effort to restore Singapore's international financial status in the wake of the stock market crisis, were to be commended.

The lack of any major natural resources had limited the scope for diversification in Singapore, thereby restricting the level of private domestic and foreign investment, Mr. Bethel observed. The service industry in Singapore had in the circumstances been the major source of foreign earnings; however, the degree of comparative advantage that Singapore achieved in that sector depended on the effectiveness of the authorities' policy of wage restraint. Accordingly, productivity must be raised in all sectors, together with an effort to minimize increases in unit labor costs and to encourage the private sector to invest in productive export-oriented enterprises. In sum, the Singapore authorities had in his view focused their stated policies in the appropriate direction. It was essential for them to continue on the course they had set if higher growth rates were to be achieved. The current world economic situation made implementation of the necessary measures all the more justified, and he hoped they would be implemented without restrictive trade practices.

Mr. Yang observed that Singapore had averaged an annual growth rate of nearly 10 percent over the past 20 years but had confronted in 1985 an unprecedented contraction in real GDP, coupled with increasing unemployment, poor profitability, and low manufacturing investment. Still, two decades of strong development had given the Singapore economy great strength. The current low rate of inflation, rising productivity, strong external accounts, and high international reserves all indicated that the economy should be able to return to a path of strong growth in due course. He was pleased to note that the authorities had stood firm in response to the adverse situation and that a wide range of measures had already been taken, mainly a sharp cut in labor costs, a reduction in taxes, a downward adjustment in the exchange rate, and an enhanced role for the private sector. His chair endorsed the staff appraisal that the adjustment measures being undertaken were appropriate to deal with the structural weaknesses in the economy and to restore growth over the medium term.

Viewed from another perspective, the current downturn in economic growth might imply that the Singapore economy was entering a maturing phase, Mr. Yang continued. If so, a revaluation of development strategies would appear to be necessary in order to chart the future course of economic policy. Although the adverse external environment was an important factor behind Singapore's current setback, the authorities had apparently drawn a lesson from the experiences they had undergone and were making an effort to adapt their own policy to changing external and internal conditions. Such a responsible attitude toward dealing with adversity was admirable.

As he was broadly in agreement with the staff's analysis on the policy issues in Singapore, he could limit his remarks to a few points, Mr. Yang commented. First, the level of savings in Singapore, amounting to some 40 percent of GDP, was among the highest in the world, and how to channel those savings into domestic productive activities was an important problem worthy of attention. It seemed that an appropriate resolution to the problem would open up ways not only of compensating for the planned phasing out of fiscal relief but also of reducing Singapore's high reliance on foreign demand and capital inflows. In pace with the maturing economy, strengthening domestic demand could be seen as a far-sighted strategy to insulate the city state from external forces. In that regard, he agreed with the staff that efforts should be made to rationalize the institutional framework, especially the financial market, in order to facilitate the investment of savings in domestic productive activities.

Second, it would be advisable for the authorities to make small and medium-sized enterprises a more dynamic component of the economy, Mr. Yang remarked. Such an approach was obviously an appropriate way of tapping private initiative, facilitating private investment, and diversifying the export base. Since the small and medium-sized firms tended to be relatively labor intensive, their invigoration would also be conducive to improving employment. For all those reasons, the authorities would be well advised to take active measures--such as tax incentives and managerial and technical support services--to foster such a development.

Mr. Polak observed that in the half decade from 1979 to 1984, following some years of phenomenal growth, Singapore had clearly overreached itself. The building program of hotels, offices, banks, and infrastructure--fortunately financed by foreign direct investment rather than by Singapore indebtedness--had oversaturated the market, and the construction industry had collapsed. The high wage policy, intended to force up productivity sharply, had at best been only partly successful and had raised the labor cost per unit of output too far above the level of other newly industrialized countries. In the circumstances, sharp adjustment had become inevitable.

It spoke well for the resilience of the Singapore government structure and its economic community that the dangers in the situation had been promptly recognized and that a far-reaching program of adjustment had been worked out and in large part adopted, Mr. Polak continued. In that regard, Singapore's past conservative financial policies, with its substantial budget surpluses, gave the economy room for maneuver rarely available to other countries entering upon an adjustment program. Singapore had the ability to increase government expenditure and lower tax rates and social security contributions for the purpose of raising competitiveness. At the same time, wage rates were being stabilized in order to recapture Singapore's place in the scale of cost among far eastern newly industrialized countries through continued rapid productivity increases.

The role of the exchange rate in the adjustment process was not fully clear, Mr. Polak continued, especially since the definition of an appropriate effective rate was by no means simple. The authorities aimed at a roughly stable rate for the U.S. dollar, primarily for reasons of confidence and because of the extreme openness of the economy. Monetary policy had correctly been made subservient to the exchange rate objective. He could endorse the approach adopted by the authorities and would indeed express some caution about the staff's suggestion to correct competitiveness by means of further adjustment of the exchange rate. In the context of economic management in Singapore, such adjustment did not seem a necessary or an effective way of further reducing real wages.

The question arose of what the approximate stability of the U.S. dollar rate had achieved in terms of the effective rate, Mr. Polak went on. The authorities stated that the dollar had a large weight in Singapore's currency basket, but the basket itself was undisclosed. The staff, which presumably used a weighting system based on imports and exports, had found an 18 percent nominal effective depreciation in the 15 months to March 1986, and he wondered whether the authorities' assessment was similar in quantitative terms. Also, he wondered whether trade weighting was the best way of measuring competitiveness, given that Singapore seemed to be looking primarily to a comparison in competitiveness with other newly industrialized countries.

Another issue on which he would appreciate further clarification was related to interest rate policy, Mr. Polak said. The chart on page 74 of the staff paper showed an apparent wide spread--7-8 percent--between prime lending and deposit rates. He wondered whether that comparison was affected by the different deflators used by the staff to define real rates. The authorities seemed dissatisfied with the spread and with the high lending rates, but attributed it to high risk premiums--which he could understand--and to declining bank profits, which seemed to suggest a lender's monopoly. He wondered how the spreads fit into the extreme openness of Singapore to foreign capital flows.

A third question deserving of attention was the tax exempt status of interest paid by the Central Provident Fund and the Postal Savings System, Mr. Polak remarked. The restrictions on the investment opportunities of those institutions might impede the development of an efficient system of financial intermediation. In that respect, he had been reminded of the Japanese system, which had also received some criticism of late. There seemed to be a clear need for a more efficient and market-related channeling of savings into productive opportunities, the more so since government finance had recently turned into deficit and the current account was expected to be in persistent surplus over the next few years. In conclusion, having observed the flexibility and managerial ability of the Singapore authorities, he shared the expectation of his colleagues that renewed growth lay ahead for the Singapore economy.

Mr. Suraisry noted that, as a result of successful, outward-looking, growth-oriented policies, Singapore had achieved an average real rate of growth of nearly 10 percent over the past two decades. The economy had been dynamic during the period and had reached an advanced stage of industrial development, despite the physical constraints associated with small economies. The record was an impressive one by any standard. However, in 1985, the growth rate had begun to decline. While it was regrettable to see a reversal of the remarkable economic performance achieved by the authorities over the years, such an outcome might well be inevitable. Furthermore, when modern technology was introduced and the economy was at an early stage of development, labor productivity tended to rise sharply. As the economy matured, however, real wages tended to increase rapidly, creating an imbalance between wages and productivity. It was in that vein that the recent slowdown in economic activity could be viewed positively as providing a warning signal against significant departures from the traditional economic policies followed in the past and as pointing to the need to adapt quickly to changing economic conditions. More specifically, the export promotion strategy had succeeded in Singapore because of the competitive position of the country's industries and the high rate of return on private capital. It was thus a matter of serious concern to note that labor costs in manufacturing in the period

1980-84 had increased by 90 percent, while productivity had increased by only 35 percent, a relationship that had led to a significant decline in the rate of return in the manufacturing sector over the same period. Even more serious, as shown in Chart 2 of the staff report, relative unit labor costs had been much higher in Singapore than in competing countries since mid-1980.

The authorities were aware of the problem in the manufacturing sector and had taken several measures to deal with it, Mr. Suraisry continued. In particular, he had been impressed by the effort to restore Singapore's competitive position, and he could support the strategy of restoring competitiveness through a containment of costs, particularly those for labor and capital. Obviously, bringing those costs in line with costs prevailing in competing countries was a necessary condition for restoring overall external competitiveness. However, if that should prove insufficient, some action in the exchange rate area might be needed, particularly if inflation remained negligible. In general, with the advancement of industrialization, it would become increasingly difficult to rely on cost containment to maintain competitiveness.

In the fiscal area, the tax concessions introduced in the 1985/86 and 1986/87 budget could be considered a short-term loss for a long-term gain, Mr. Suraisry went on. Such measures, despite the tax revenue losses associated with them, should encourage investment and, consequently, enhance economic growth in future. The 6.5 percent of GDP budget deficit estimated for 1986/87 appeared to be on the high side. Nevertheless, if future budgets became less ambitious in boosting economic activity, the deficit should not be much cause for concern, since Singapore had one of the highest gross national savings ratios in the world. In that connection, Mr. Jaafar's indication that his authorities were committed to a long-term balanced budget was reassuring. He had noted the staff's suggestion for increasing the role of indirect taxes for the purpose of promoting exports, and he saw merit in the suggestion if the measures taken to reduce production costs proved to be insufficient for restoring competitiveness. However, if the measures turned out to be sufficient, he agreed with the authorities that more neutral tax incentives would be better, particularly from an efficiency point of view.

Like many of the newly industrialized countries, especially those in south-east Asia, Singapore had in its development strategy chosen the export sector as the leading sector for growth, Mr. Suraisry noted. By adopting the appropriate policies, acquiring a sophisticated class of skilled labor and entrepreneurs, and achieving a better allocation of domestic and foreign resources, Singapore had succeeded in exploiting its comparative advantage and in easing the balance of payments constraint on growth. At the same time, the economy had become quite sensitive to developments in demand and trade policies in the world economy. In 1980, the ratio of total exports to GDP had been above 150 percent. Protectionist measures against Singapore's exports could, therefore, have a devastating impact on its development strategy. He shared the authorities' concern about such measures and hoped they would be eliminated, since they were of benefit to no one. In sum, Singapore had achieved an impressive record of economic development and sustained growth in the past 20 years. While their achievement had lately been challenged by serious problems, the authorities were making a determined effort to overcome those problems.

Mr. Agah observed that, until 1984, Singapore's economic and financial performance had been characterized by strong real GDP growth, a government budget surplus, and low inflation and unemployment rates; 1985 had been a turning point in which output growth had fallen by 2 percent, the government budget had turned into deficit, and the unemployment rate had nearly doubled. However, the current external account had strengthened further, and the inflation rate had fallen to 0.5 percent. As an export-oriented, newly industrialized country, Singapore was extremely sensitive to external factors. Investment profitability also played an important role in the economy. During 1985, the sluggish activity in major industrial countries and in the ASEAN region, which had been accompanied by a further deterioration in the country's competitiveness and profitability, had brought about a downturn in Singapore's overall economic performance. Wage policy and the policy of upgrading the skills of the labor force in recent years had resulted mainly in a more substantial increase in labor costs than in productivity and had led to a 17 percent decline in private sector investment. Public sector investment had also decreased with the completion of major projects, particularly large-scale public housing. Taking into account a moderate rise in total consumption, aggregate domestic demand had registered a fall of 3.5 percent.

The corrective fiscal measures implemented by the authorities to restore the competitiveness and profitability of the economy during 1985 had been steps in the right direction, Mr. Agah considered. Those measures were in line with the recommendations by the Singapore Economic Committee, including an integrated approach aimed at enhanced labor productivity growth and at reducing excess business costs through severe wage restraints so as to remove the established expectation of regular wage increases. Those measures had been accompanied by specific tax relief, which had turned the government budget into a deficit of 0.7 percent of GDP for the first time since Singapore's independence.

On the monetary side, domestic credit by the banking system had declined, mainly because of sluggish demand by the private sector, Mr. Agah remarked. While the authorities were appropriately urging banks to use the scope made available by the current economic recession to reduce lending rates, a further reduction in domestic interest rates--which were high in real terms--and in intermediation costs would further promote investment incentives and help the private sector contain capital and other related production costs.

Remarking on the external sector, Mr. Agah observed that the overall balance of payments position had strengthened further, despite the sluggish demand in the region and growing protectionism in most industrial countries. During 1985, the fall in exports had been more than offset by a substantial decline in imports. Trade and current account deficits had narrowed to US$3.0 billion and US$0.3 billion, respectively. However, the current account deficit had been more than offset by a sizable surplus in the capital account, and gross international reserves had risen to a comfortable level of US$12.8 billion, equivalent to more than seven months of 1986 projected imports.

He shared the view of the authorities that economic performance in 1986 was likely to show a second year of declining output with a surplus in the external current account, mainly due to a higher projected reduction in imports than in exports, taking into account the continued weak external and domestic demand and the outturn for the first quarter, Mr. Agah remarked. However, with the timely implementation of the fiscal and monetary policies outlined by Mr. Jaafar, the medium-term prospects appeared promising.

The staff representative from the Asian Department observed that the exchange rate had been the focus of questions raised by most Executive Directors in the course of the discussion. Several of them had wondered whether the exchange rate should not perhaps have played a more active role in securing adjustment, while others had queried whether the staff should even be encouraging the authorities to pursue an active exchange rate policy. Ms. Bush had suggested that the authorities were perhaps focusing too much on the nominal exchange rate, and Mr. Polak had wondered what the authorities' index would show relative to the staff index. The staff could not make the comparison Mr. Polak asked for, as the basket remained undisclosed. Recent events suggested, however, that the authorities had not been focusing on stabilizing the nominal effective exchange rate. Between December 1985 and May 1986, there had been a nominal effective depreciation of the exchange rate by some 13 percent, approximately 4 percentage points of which had taken place after the consultation discussions. If there were concerns about whether competitiveness had adequately been restored on the wage side, consideration should perhaps be given to some further strengthening of competitiveness through the use of the exchange rate.

Remarking on the real economy, the staff representative noted that, while indications were not definite, there were signs that the economy was picking up. Business surveys indicated a restoration of competitiveness within the business community, and there appeared to be a number of new commitments by multinationals for investment in Singapore. More generally, investment commitments for the first quarter of the year were up 50 percent from the previous year, although it remained to be seen whether those commitments would be realized. Even if they were, the percentage increase should not be cause for complacency, since the base year had witnessed very depressed investment.

The authorities in Singapore were concerned about the competitiveness of the economy as a production base and as a base for providing services relative to those that could be provided by other newly industrialized countries, the staff representative commented. In that respect, they had looked particularly at the tax incentives offered to exporters of services in other newly industrialized countries and had attempted to be competitive. Since the discussions between the staff and the authorities, numerous newspaper articles had suggested that the authorities had given additional tax incentives to underwriting activities and to countertrade activities. While the accuracy of those reports could not be determined, it was clear that the authorities had over the past 3-4 years given extensive tax incentives to the financial community and others to establish their multinational headquarters in Singapore.

On the fiscal side, the staff representative recalled a number of questions relating to the budget deficit for 1986/87 and beyond. The deficit for 1986/87 was quite large, at S$2-2.5 billion, although the savings intermediated through the Government from the Post Office Savings Bank and the Central Provident Fund amounted to S$3-4 billion per year, which should make financing of the deficit relatively easy. Also, in relation to the effort to facilitate the financing of the business sector and investment by Singaporeans, the authorities were attempting to develop a market for government securities and, eventually, to move toward open-market operations. Many Directors had noted the need for additional monetary instruments, which the development of a financial market would facilitate.

In response to those who had questioned the priorities of the Government for public sector investment, the staff representative considered those priorities to be fairly conservative. The authorities had indicated an interest in completing a number of infrastructure projects dealing with drainage, land reclamation, roads, and the housing program; but they did not envisage many large new initiatives, which was why a significant phase-down in government expenditure for investment purposes was foreseen.

The staff had asked the Singaporean authorities whether additional reliance might not be placed on indirect taxes, the staff representative said. A value-added tax that could be rebated, for example, would be attractive for exports and could be a useful substitute for the high direct taxes still prevailing in Singapore. The authorities had indicated that such a tax was under review but that a number of difficulties could be experienced in implementing it. A value-added tax tended to be difficult to rebate for tourist expenditure, for example, and it would be important to develop a system that would not adversely affect tourist expenditure. On a related matter, the question had been raised of what the fiscal impulse might be from the 1986/87 budget, which she understood to refer to the discretionary measures that might have been put in place to stimulate activity. Those were mostly revenue-raising measures and, as far as the staff knew, would yield the equivalent of 1.5 percent of GDP over and above the yields related to those measures taken in the mid-1985 package.

Responding to those who had noted the wide spread between the prime lending rate and the deposit rate in Singapore, the staff representative observed that there were a number of reasons for the disparity, although the primary one concerned variations in maturities. If one looked at the rates in nominal terms for comparable maturities, the spread would be only 1/2 percentage point. However, the maturity for the deposit rate was 12 months, while the prime rate maturity tended to be only 7-8 days. Another reason for the disparity was the fact that the deflators had moved rather differently.

The importance of regulatory reform to encourage investment in Singapore, particularly in the securities market, had been noted by Ms. Bush, the staff representative continued. Two major bills had been passed in Singapore that should encourage confidence; and, recently, a marked pickup in activity on the stock market had been observed. That increase, together with the dramatic rise in prices of stocks, could indicate some restoration of confidence.

On the external side, the staff representative noted the importance of the general system of preferences for the growth of Singapore's exports. In that context, attention should be drawn to Singapore's very open trading system, which did not look to domestic import substitution so much as toward the encouragement of competitiveness in the production of both goods and services domestically. That policy had stood the test of time over the past 20 years of dramatic growth in Singapore.

Mr. Jaafar agreed with those who had noted that the current recession in Singapore was unprecedented, following two decades of phenomenal growth. The past two years marked an important turning point as perhaps the end of the extraordinary sustained growth rates of 9-10 percent as the economy grew to maturity. The latest projections were for a less rapid pace of growth, albeit still at 4.5-5 percent until the end of the decade. It was important to ask whether or not the economies already put in place or contemplated would prove effective in ensuring that those projections were realized. The Singapore authorities recognized that, beyond the problem of the recession connected with the slump in exports were other problems, more structural in nature, that would have to be overcome. First, the structural shift in market demand for oil refineries and shipyard services were not unrelated to the global oil situation and the comments by his colleagues on the slump in construction and heavy investment in those areas over the past five years--at the expense of other productive investment such as machinery, plant, and other equipment--were well taken. Recovery in the construction sector would be slow, but new policies were being put in place to encourage investment in other areas, particularly manufacturing, to take up the slack.

Another issue to which his colleagues had paid attention in the course of the discussion was the trend toward a loss of competitiveness, Mr. Jaafar continued. In the absence of a response by the Government, that loss of competitiveness could become a liability, and he was thus pleased to note that progress was being made through policy measures implemented over the past 2 1/2 years to restore competitiveness. The authorities' immediate response to the challenge was exemplary of the kind of flexibility and pragmatism with which policy decisions were adopted in Singapore. In that regard, taking into account the policy of restricting wages, the large tax concessions in 1985 and 1986, and the cut in the Central Provident Fund contribution from 25 percent to 10 percent, a strong improvement in competitiveness might already have been realized.

Similarly, on the external side, the exchange rate of the Singapore dollar had remained flexible, depreciating over the past year or so by nearly 18 percent, Mr. Jaafar commented. In addition, domestic inflation had been lower than in Singapore's major competitors and trading partners. It should perhaps be noted that a competitive edge was vital to Singapore, as trade in proportion to GDP was extremely high. The potential for growth in the domestic market was limited, given the small size of the population. In that regard, he had noted with interest Mr. Polak's comments on exchange rate policy, which should be weighed against the remarks of other Directors and the staff.

Remarking on the report of the Singapore Economic Committee, Mr. Jaafar observed that the Committee had been given the task of conducting a comprehensive review of the Singapore economy. It was important to recognize at the outset that most members of the Committee were from the private sector, a composition that had led to the frank and critical appraisal in the report published in February 1986, some two months before the 1986 Article IV consultation. The recommendations in that report were far-reaching, including, in particular, a call for a sharp cut in Central Provident Fund contributions, a recommendation that only a year earlier would not have been considered. Other recommendations by the Committee were aimed at revitalizing and strengthening the private sector, including through the attraction of foreign direct investment. He was happy to be able to inform his colleagues that most of the recommendations had already been implemented and that he was optimistic that the Singapore economy would rebound strongly in the years through 1990.

The Acting Chairman made the following summing up:

> Directors agreed with the thrust of the appraisal in the staff report for the 1986 Article IV consultation with Singapore. They observed that the period 1985-86 appeared to be marking a turning point in Singapore's economic performance, characterized by the economy's first decline in output and its first budget deficit, and, in 1986, by a current account surplus. Directors also noted that in the medium term, real GDP growth was likely to be slower than in the past, as Singapore's economy matured.
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> Directors observed that while a number of causes of the present recession were external--for instance, the weakening of economic activity in other countries and the difficulties in the world oil and shipping markets--domestic factors had also played an important role. Most notably, in the first half of the 1980s,

labor costs in Singapore had increased dramatically relative to those in the main trading partners; and an increasing proportion of investment had been channeled into construction activity.

Directors welcomed the comprehensive policy package the authorities had implemented in response to the weakening of Singapore's economic performance, and they emphasized the importance of improving the business climate. Directors particularly commended the measures the authorities had taken to restore competitiveness through wage restraint, significant cuts in other labor costs, including cuts in employers' contributions to the Central Provident Fund, and an array of tax measures, including reductions in corporation and property taxes. These steps, together with the substantial nominal effective depreciation of the Singapore dollar over the past year, should result in a significant strengthening of Singapore's competitive position. It was observed, however, that it was difficult to judge whether an appropriate level of competitiveness had been achieved. Thus, if the hoped-for upturn in investment and exports did not materialize, further measures--which in the view of a number of Directors could appropriately involve an active use of the exchange rate policy--might be necessary. Directors noted the importance of greater flexibility in wage determination in the coming years and they agreed on the need to limit wage increases to productivity growth.

Directors agreed that in current circumstances, the stance of financial policies was broadly appropriate: although the increase in the fiscal deficit in 1986/87 would mark a temporary setback for the authorities' objective of reducing the size of the public sector, it should provide a boost to domestic activity without crowding out the private sector. However, they stressed the importance of avoiding a sustained deficit and welcomed the Government's intention to establish budgetary balance in the medium run.

On the monetary side, Directors observed that the traditional withdrawal of domestic liquidity by the public sector was likely to be sharply attenuated as the budget moved into deficit, and, at the same time, the current account was expected to move into surplus. Accordingly, a thorough review of the instruments of monetary control in Singapore would be useful. It was also observed that the current institutional framework might constrain the development of a more efficient domestic market for financial assets, since a large portion of savings was severely limited for investment in productive activities. In this connection, Directors welcomed the introduction of the new Security Industries Bill, aimed at more effective supervision of the stock market, and the authorities' intention to foster the development of a market in government securities.

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

3. SRI LANKA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Sri Lanka (SM/86/139, 6/16/86). They also had before them a report on recent economic developments in Sri Lanka (SM/86/143, 6/23/86).

Mr. Jayawardena made the following statement:

My authorities are grateful to the staff for the comprehensive and excellent papers prepared for the 1986 consultation and for the balanced points of view contained therein. They are broadly in agreement with the analyses and consider them very helpful in charting the future course of economic policy. I shall, therefore, limit my observations to highlight some salient features and problems.

Directors will recall how Sri Lanka abandoned an increasingly regulatory economic regime of over three decades of slow growth and rising unemployment and how it changed over to a path of economic liberalization in 1977. Since then, economic growth has more than doubled, unemployment has been halved. Near self-sufficiency in basic food supplies (rice) has been achieved. The economy has been substantially diversified, in the sense that the virtual dependence on three primary products (tea, rubber, and coconut) for export earnings has been substantially reduced. Infrastructure has been rehabilitated and improved. There has been some concern that the tilt toward a market-oriented economy might jeopardize the social gains of the previous years, for which Sri Lanka was justly praised. But recent studies (by the World Bank) have shown that the policies have not been detrimental to the poor; in fact, they appear to reinforce the desirability of pursuing more open economic policies.

The staff has shown how new problems have emerged, despite the successes; and how the pace of policy reform waned despite a continued commitment to liberalization. This could be largely explained by the difficulties Sri Lanka experienced in undertaking the reforms at a most inhospitable time, with a large rise in oil prices, the subsequent world recession and, more recently, a sharp deterioration of terms of trade. However, there is no doubt that, if not for the reforms, Sri Lanka would have come out much worse than today. An important factor which helped Sri Lanka to persist with the reforms in the manner it did was the strong support from the Fund, the Bank, and the international donor community.

Directors will recall that 1985 policies were originally framed in the context of a slight weakening of terms of trade, following the sharp improvement in the previous two years, which would result in a higher external current account deficit of about 6 percent of GDP (excluding grants) and a further but modest increase in reserves. However, export prices (especially tea) fell dramatically, contributing to another drastic fall in terms of trade of 15 percent. The external current account deficit widened to 9.6 percent, and an overall payments deficit of SDR 111 million was financed by a drawdown of reserves, which had been built up in the previous two years by cautious management. The external debt service ratio (relative to current receipts) rose from 15 percent to 19 percent, reflecting the weaker export earnings. This ratio was contained at this level because of the repayment of short-term commercial borrowing during the previous two years.

As in the past, the sharp deterioration in terms of trade had a direct impact on fiscal performance. When combined with urgent but unanticipated outlays on security, the anticipated 1.5 percent of GDP reduction in the fiscal deficit (before grants) was not attainable. In fact, the deficit rose by nearly 5 percent of GDP, which had to be financed from the domestic banking system. By the time the magnitude of the expenditure overruns was assessed, especially of security-related expenses, it was too late to undertake any corrective policies which would have made an impact during the financial year.

Whereas these developments once again demonstrated the continued vulnerablility of the economy despite recent achievements in growth and diversification, there were certain positive developments too. The economy continued to be buoyant, in that economic growth was sustained at previous years' level of 5 percent. Agricultural output grew by 9 percent, industry by 5 percent, and services by 4 percent. The coconut industry was liberalized, and the general reduction of export duties restored incentives to the export sector. Inflation decelerated sharply to 1 percent at the end of 1985 (on an annual average basis, CPI, which rose 17 percent in 1984, actually declined by 1 percent in 1985), largely on account of favorable output performance and stringent monetary policy. Growth of private sector credit slowed down, and the overall increase in credit of 19 percent eventually reflected growth in credit to the public sector. Interest rates remained highly positive in real terms, showing a stickiness in a downward direction, at a time of declining inflation. Closing down of some unprofitable public enterprises, especially the large fertilizer factory, and retrenchment of excess staff in many others provided relief to the budget.

On the whole, however, the evolution of economic variables during 1985 was worrisome. Reflecting the weakening financial situation, and aided by a softening dollar and better domestic price performance, the exchange rate is estimated to have depreciated by over 15 percent in real effective terms during 1985.

Arresting the aforesaid fiscal slippage during 1986 was the main motive of my authorities, when presenting the budget for 1986. They envisage a reduction in expenditure from 36 percent of GDP in 1985 to 31-32 percent in 1986. Given the need to enhance security expenditure by nearly 1 percent of GDP, this reflects a sharp containment of nonsecurity current expenditure. Any failure on this front would entail a cutback in capital expenditure. With revenues remaining at a high 21 percent of GDP, it should be possible to reduce the fiscal deficit from 14 percent to 11 percent of GDP (from 12 percent to 9 percent, after grants); foreign financing accounts for nearly one half of this deficit. My authorities are determined to hold onto this fiscal scenario, and the latest advance reports on revenues (running slightly higher) and expenditures (on target) indicate that this objective is achievable, barring unforeseen developments.

My authorities are also hopeful of achieving the monetary targets for 1986 of an increase in M2 of the same level of last year. Some direct and selective controls of the monetary system, which have proved effective in the past, may have to be continued, until further reform of the financial sector (following the Central Banking Department's mission report) could be achieved by eliminating structural rigidities.

The external current account deficit (including official transfers) is expected to decline to 6 percent of GDP in 1986, which equals the foreign aid disbursements during the year. Staff have drawn attention to the downside risks associated with this forecast, but more flexible exchange rate management (the real effective depreciation of the rupee in 1986 so far is estimated to have virtually corrected the real appreciation since 1980), the reduction in export taxes and the simplification of export procedures, and the anticipated reduction in imports should help in minimizing these risks. My authorities are now engaged in identifying further structural reforms, some of which have been referred to in the staff reports, with a view to early implementation.

The current perspectives of the medium-term balance of payments outlook indicate the feasibility of progressively reducing the external current account deficit to a manageable 4-5 percent of GDP by 1990, while economic growth is maintained at about 4-5 percent per year, and gross reserves are maintained at the level of two months' imports. This would result in the external debt service ratio rising to 26 percent of GDP by 1987 and declining thereafter to a manageable 19 percent by 1990, after reckoning some very modest commercial borrowings to meet financing gaps.

While my authorities consider this scenario as manageable, they are acutely aware of the downside risks and the limited room for maneuver, although the scenario itself is based on certain modest assumptions of export growth and current and capital inflows.

The World Bank-assisted rehabilitation program of the tree crop sector is well on its way, and although the results of this effort are expected to take time to materialize, with better incentives, an earlier response could be anticipated. The greater flexibility of exchange rate management should also enhance export incentives in the nontraditional sectors. With the anticipated decline in the capital-output ratio, following the completion of major public investment projects, with the proposed shift of resources from the public to the private sector, with the softening of energy prices, and with increasing import substitution, the anticipated moderation of imports should be achievable. In this regard, the containment of the fiscal position would be of paramount importance. A greater domestic resource mobilization should be realizable with ongoing improvements in tax administration and continued incentives for savings. Other structural reforms will be needed to eliminate remaining distortions and to improve incentives, but the response of the private sector will also be predicated on another factor--confidence.

With a view to strengthening confidence, my authorities intend to pursue a two-pronged approach. First, they will actively pursue an early settlement of the security problem by negotiation, while intensifying efforts to maintain law and order and to protect citizens and property. Secondly, my authorities intend to present a framework of economic and fiscal policies over a three-year period in the forthcoming budget presentation, which will help reduce uncertainties relating to medium-term policy orientation, and help instill greater confidence in the private sector. This exercise would include contingency options to achieve the medium-term objectives if any unanticipated slippages occur, thus elevating economic objectives in the Government's priorities and striving to avoid the kind of circumstances which emerged during 1985. The thrust of the contemplated policies includes strengthening of fiscal management, broadening the export base, and more generally, measures to increase the efficiency of resource use in the economy, particularly in the public sector.

Mr. Ismael recalled that during discussion of the staff report for the 1985 Article IV consultation with Sri Lanka, many Directors had commended the authorities for the strong performance of the economy in 1984, and for the substantial progress they had made in reducing external and fiscal imbalances. While the economy had continued to perform reasonably well in 1985 in terms of growth and inflation, the staff report indicated that the progress toward economic adjustment had experienced some setbacks as a result of adverse external and domestic developments. Sharply lower export prices had brought a significant decline in exports, reversed the improvement previously made in the current account position, and adversely affected government revenue. A worsening security situation and the consequent need to strengthen national resilience had hampered effective control of expenditures and had led to substantial slippages in budgetary performance. Deterioration in the security situation had also adversely affected confidence in the business community.

While the adequacy of corrective action taken by the Government to adjust to the situation might be open to question, he felt that the authorities' responses in most policy areas had been generally appropriate, Mr. Ismael continued. Most remarkable in that respect were the further tightening of monetary policy, a more flexible exchange rate management, and the continued restraint on imports and commercial borrowing. The adjustment program for 1986 already in place was also commendable and reflected the continued commitment of the authorities to successful economic adjustment.

Remarking on more specific aspects of Sri Lanka's adjustment effort, Mr. Ismael said that he could appreciate the dilemma faced by the authorities in attempting to raise government revenues while providing fiscal incentives to exports and the private sector. It was important to strike a balance in such a way that steady progress in reducing the fiscal imbalance could be assured. He shared the staff's view that the extension of various exemptions and preferential tax treatment would tend to weaken the tax system and might lead to inefficient allocation of economic resources. In the effort to broaden the revenue base of the Government while creating a favorable tax climate for the business sector, the authorities should give serious consideration to tax and tariff reforms such as the reform currently being planned with World Bank assistance.

Given the limited scope for raising revenues in the short run, however, he agreed that efforts must be focused on reducing the level of government spending, Mr. Ismael commented. In that respect, he welcomed the decision to restrain expenditures at their 1985 level and to increase revenues by about 1 percent of GDP in the 1986 budget. Also welcome was the planned 3 percent reduction in the fiscal deficit in relation to GDP, which might be the best the Government could achieve under difficult circumstances. Still, it was essential that further slippages in the budget be minimized in order to restore the progress in the adjustment process and to prevent slippages in other policy areas. Measures already taken toward that end, on both the expenditure and revenue sides, were encouraging; but the authorities must be prepared for additional or contingency measures to deal with unforeseen slippages.

On monetary policy, Mr. Ismael considered that the effort to keep the target growth of M2 at the 1985 level was consistent with the objective of maintaining reasonable price stability. An increase in the growth of credit to the private sector was also a welcome development, although that increase would have to be realized in line with the outcome of the budget and the balance of payments. The authorities' intention to increase the role of market prices in determining the level of interest rates and to rely increasingly on open market operations in the conduct of monetary policy were commendable. He urged the authorities to move expeditiously to realize their intentions: free market determination of interest rates would not only lead to a more efficient allocation of resources but would also eliminate the necessity to use a credit ceiling as an instrument of monetary control. Experience had shown that market-determined interest rates would also serve as a safety valve against capital flight.

Remarking on external policy, Mr. Ismael welcomed the continued restraint on imports and commercial borrowing, a restraint that was particularly appropriate in the face of the projected sharp rise in the debt service burden and the uncertainties in the export market. The various initiatives taken by the authorities in several areas with the aim of strengthening the balance of payments were also commendable. Particularly noteworthy in that regard were the reforms of the tariff structure, the liberalization of the coconut industry, and the rehabilitation of the estates producing products for export. It was to be hoped that further liberalization and corrective measures would follow from the reviews being undertaken of port, customs, and exchange control procedures, and administrative procedures aimed at reducing the cost of exporting.

An essential element in the effort to strengthen the external sector was the maintenance of an exchange rate that could ensure adequate profitability for export and import substitution industries, Mr. Ismael considered. Relatively flexible management of the exchange rate by the authorities during 1985--which had resulted in a 15 percent depreciation of the rupee--had been a correct response to the weakening export market. However, he tended to believe that further flexible exchange rate management was required to help strengthen the balance of payments and to offset the appreciation of the currency in previous years.

He agreed with the staff that the Sri Lanka authorities' target of maintaining economic growth of 4-5 percent in the long run called for a development strategy focusing on diversification and expansion of export-oriented agriculture and on developing a more efficient industrial sector, Mr. Ismael said. The achievement of such goals would require a reasonable level of intermediate and investment goods imports. The assumption of a sharp decline in consumer, intermediate, and investment goods imports used in the staff's baseline medium-term scenario did not seem consistent with that growth strategy; nor was it realistic to expect that the incremental capital output ratio and the import intensity of investment could be brought down significantly. He expected an import growth even higher than the projected 2.5 percent, if the medium-term growth target was to be realized. According to the staff's projection, that would require more than 15 percent export growth if the targets for the financing gap, debt service, and the current account deficit were to be achieved. Under current market conditions, which were characterized by depressed commodity prices and protectionist tendencies in many industrial countries, the challenge to the Sri Lanka authorities was a formidable one and an extremely vigorous and comprehensive adjustment effort would be a necessary condition for achievement of medium-term goals. But it would never be a sufficient condition if the trade environment did not improve. A more open trade policy in industrial countries was an absolute requirement for a successful adjustment in Sri Lanka as well as in other developing countries. In conclusion, he could support the proposed decision.

Mr. Sugita observed that economic reform since 1977, coupled with a broad public investment program, had created a favorable environment for rapid economic growth in Sri Lanka. The annual growth of real GDP had doubled, and there had occurred a marked expansion in the private sector. Also noteworthy had been the attainment of near self-sufficiency in rice production and reduced dependence on imported energy sources. However, persistent weaknesses--particularly in the area of fiscal policy and in the balance of payments--had been highlighted by developments in 1985. While real GDP had been maintained at 5 percent and inflation had been substantially reduced, a sharp decline in commodity prices and an increase in security spending had adversely affected the economy, with both the fiscal and external deficits rising to an unsustainable level. While there had been some recent signs of a pickup in tea prices, that prospect was fraught with considerable uncertainty. Moreover, the fact remained that the economy was highly susceptible to fluctuations in price developments for a few specific commodities, and the problem of security was likely to last for some time.

In the circumstances he had described, the Sri Lanka authorities had little choice but to intensify their adjustment effort in order to achieve a viable balance of payments position over the medium term, Mr. Sugita continued. Emphasis must be placed on strengthening the financial position of the public sector; but an effort must also be directed toward export growth and diversification.

Remarking on a few key policy areas, Mr. Sugita observed that, based on preliminary data, the fiscal deficit in 1985 had amounted to 14.3 percent of GDP, much larger than the initial estimate of 9.4 percent. The main area of expenditure overruns had been in defense, but other factors had contributed to the overruns, which demonstrated the inadequacy of expenditure control procedures. In 1986, the objective was to reduce the fiscal deficit by 3 percent of GDP; toward that end, the authorities had introduced a number of measures, including a limitation on supplementary appropriations, a 5 percent reduction in the operating budgets of ministries, and a reduction in subsidies. However, given the past record of expenditure overruns, a considerable effort would be required to contain spending within the target.

The operation of the public enterprises must also be improved, Mr. Sugita continued. The inefficiency of the public enterprise sector was demonstrated by the fact that its output in 1985 had been only 6 percent higher than the level in 1977, despite the rapid industrial growth in the private sector. In that regard, he noted that the Fund's Bureau of Statistics was providing technical assistance to the Sri Lanka authorities with a view to improving the reporting of financial accounts of the public enterprises; moreover, the Industrial Policy Committee set up by the Government was defining overall industrial policy. It was to be hoped that those efforts would lead to improved efficiency in the public enterprises. On the revenue side, the authorities needed to take measures that would broaden the tax base and increase the elasticity of the tax system.

In the area of monetary policy, Mr. Sugita welcomed the authorities' objectives for 1986, although he shared the staff's concern that a slippage in the budget could easily jeopardize their achievement. Hence, he urged the authorities to be alert to fiscal developments and to take corrective measures as warranted. He could also support the authorities' intention to increase the role of market forces in determining the level of interest rates and to rely increasingly on open-market operations in the conduct of monetary policy.

In 1985, the current account deficit in Sri Lanka had widened sharply, mainly due to a deterioration in the terms of trade, Mr. Sugita observed. However, other factors had contributed to the deterioration of the current account, including the decline in garments and textile exports, which had been a major component of export growth until 1984. That decline was attributed to increasing protectionist pressures abroad. Another disturbing factor was the deterioration in the services account, which was associated with an increase in interest payments and a fall in the number of incoming tourists. It was the responsibility of the developed world to keep their markets open to imports from developing countries; but it must be recognized that the underlying balance of payments position in Sri Lanka had deteriorated in large part because of the security problem and an increased debt burden as well as the economy's chronic vulnerability to fluctuations in commodity prices. Those factors underscored the need for substantial domestic adjustment and export diversification. In addition, an appropriate industrial strategy would be essential, and he welcomed the establishment of the Industrial Policy Committee, which would be given the task of delineating such a strategy. The Sri Lanka economy was highly responsive to appropriate incentives, as evidenced by the rapid growth of the textile and garment sector during the early 1980s. If the proper overall industrial policy was in place and if such a policy was supported by an active exchange rate policy, the prospects for the balance of payments over the medium term could well improve. Finally, he could support the proposed decision.

Mr. Engert, noting that he was in broad agreement with the staff's analysis, observed that one aspect of the Sri Lanka experience could serve as a useful lesson to others. That aspect concerned the authorities' effort, beginning in 1977, to liberalize the economy. That effort had brought substantial benefits to Sri Lanka without adversely affecting the poorest members of the population; indeed, as Mr. Jayawardena had observed, the evidence suggested that even greater liberalization would be appropriate. He had been impressed by the Sri Lanka experience and encouraged the authorities to take further steps to develop a more liberal and competitive economy.

Fiscal policy was central to a number of the problems faced by Sri Lanka, Mr. Engert considered. The authorities were apparently planning a substantial decrease in nondefense spending, which accounted for the entire planned decline in the fiscal deficit--before grants--of 3 percent of GDP in 1986. While agreeing that their adoption would represent significant progress, and notwithstanding some useful steps already taken to control expenditures, he shared the staff's concerns regarding the degree of demonstrated commitment to reaching the goal.

About half of the revision of the expenditure projections for 1986 were the result of greater net lending and capital expenditure, Mr. Engert remarked. That fact, plus the indication that the need to consider supplementary provisions had come early in the fiscal year, provided evidence in support of the staff's view that effective management of expenditures seemed to be lacking and that the budgetary process did not embody or reflect clearly articulated priorities. A particularly noteworthy example of the latter, which had caused the Sri Lanka authorities some difficulty, was the apparent ambivalence or lack of clarity regarding the role of the public sector enterprises in Sri Lanka. In that connection, he welcomed the work of the Administrative Reform Committee and the World Bank's involvement in addressing the role of the public sector in Sri Lanka; and he agreed with the staff that potential savings through the reform of the public sector enter prises could be significant.

He shared the staff's disappointment in the recent efforts to enhance government revenues, Mr. Engert went on. Despite recent changes in the tax provisions, the elasticity of the tax system was low, and numerous exclusions and exemptions remained. In the circumstances, he welcomed the involvement of the Fund's Fiscal Affairs Department in improving the authorities' revenue-raising effort. He would be interested in any comment that the staff or Mr. Jayawardena might wish to make concerning the rationale of the tax structure and the prospects for increasing its elasticity.

The importance of dealing effectively with the fiscal deficit was an integral part of the medium-term outlook presented by the staff, Mr. Engert remarked. As noted on page 24 of the staff report, it was estimated that public sector savings would need to increase by about 3.5 percent of GDP by 1990. However, despite the assumption of an increase in public sector savings, the medium-term outlook was problematic, which should underscore the need for prompt and effective fiscal action. A timely resolution of Sri Lanka's security problems might generate the needed savings, although the fiscal improvements described by the staff remained desirable on efficiency grounds and in order to ensure that Sri Lanka's fiscal balance moved to a sustainable and noninflationary position.

The staff had pointed out that the medium-term projections assumed a major change in the relationship between incremental capital and output and in the investment intensity of imports, Mr. Engert continued. He would appreciate staff comment on the likelihood of those assumptions being realized, particularly in view of the staff's opinion that higher real growth of intermediate and investment goods than was projected would be more consistent with the authorities' growth objectives. He would also welcome staff elaboration on the comment that such higher import growth was feasible without additional external financing, provided that a supportive policy framework was established and maintained. A fuller discussion in the report regarding any differences of opinion between the staff and the Sri Lanka authorities concerning the capital-output ratio and the investment-intensity of imports would have been useful.

In the area of monetary policy, the integrity of the fiscal balance was also important, Mr. Engert remarked. As the staff had noted, slippages in the budget could jeopardize the monetary objectives. In addition, he joined the staff in advising caution in the reduction of deposit rates, and he encouraged the authorities to pursue their intention to increase the role of market forces in the determination of interest rates and to make greater use of open-market operations in the conduct of monetary policy. In connection with the institutional reforms needed to achieve those goals, he welcomed the technical assistance to be provided by the Central Banking Department and urged the Sri Lanka authorities to adopt the recommendations of the technical assistance mission, some of which had been outlined on pages 27 and 28 of the staff report. He also encouraged them to develop more active money and capital markets in order to improve the mobilization and distribution of scarce capital resources and to improve the scope and effectiveness of monetary policy. As indicated in the staff report, the stance of monetary policy in 1986 was consistent with inflation in the 7-8 percent range. A lower inflation performance, together with an appropriate fiscal stance, would be helpful in securing the competitiveness needed to improve export profitability and strengthen the balance of payments.

Increased protectionism abroad, particularly in the textile market, had greatly compounded Sri Lanka's difficulties in establishing a viable external balance, Mr. Engert considered. In that regard, improved export performance was dependent not only upon the adoption of appropriate policies in Sri Lanka but also upon the avoidance of increased protection in its major trading partners. Finally, the Sri Lanka authorities should be commended for their effort to view the forthcoming budget from a medium-term perspective and for the inclusion of contingency options in the budget exercise. Such an approach should strengthen confidence in the Sri Lanka economy.

Mr. Yang observed that Sri Lanka's economy had continued to develop positively in 1985. Economic growth had been sustained at a reasonable level, and inflation had decelerated significantly. More important, the undertaking of economic liberalization had continually been on course. However, the current account deficit had widened, due to a drastic fall in export prices, and the fiscal position had deteriorated as well, resulting mainly from expenditure overruns. He was happy to note that, as a primary policy goal in 1986, the authorities were determined to arrest the fiscal slippage. To improve the external position, they had undertaken a number of measures, including a more flexible exchange rate policy, export promotion, and a curb on imports. It was expected that, in 1986, the authorities would make further progress in tackling the adverse external environment and internal structural rigidities.

Export performance was of vital importance to the Sri Lanka economy, Mr. Yang considered. With a narrow export base, the economy was exposed to external developments, and prevailing uncertainties in the export market had posed a serious challenge to the economy. In the circumstances, it would seem imperative for the authorities to strengthen and diversify the export sector. In that regard, a comprehensive development strategy that coordinated efforts on various fronts was essential. He understood from Mr. Jayawardena that the authorities intended to adopt such a strategy, and he welcomed its prompt implementation.

The public sector enterprises in Sri Lanka accounted for some 40 percent of the value added in manufacturing, Mr. Yang observed. The performance of those enterprises thus had a great bearing on the fiscal situation. As the staff had noted, many public enterprises remained inefficient and overstaffed. Although the authorities had taken some important steps to correct the inefficiencies, further prompt and forcible measures were needed to accelerate the corrective process.

Mr. Fox noted that Sri Lanka had made substantial progress over the past decade or so, since the authorities had instituted a more liberal economic policy. More recently, however, a number of problems had resurfaced, especially since the reversal of the sharp increase in tea prices in 1984, and those problems had been exacerbated by security difficulties in Sri Lanka. The fiscal deficit was running at an unsustainable level and, without sharp restraint, the situation would escalate. On the external front, there was little room for maneuver: reserves were low; prospects for traditional exports were weak; and the export sector was undeveloped. Higher commercial borrowing must be avoided; the rise in the debt-servicing ratio that had already taken place was probably the maximum that could be sustained.

A number of Sri Lanka's problems were clearly due to factors beyond the control of the authorities, Mr. Fox continued, notably, the declines in the terms of trade. And Sri Lanka's security problems had exacerbated the fiscal difficulties and had generally undermined confidence. However, the need for fiscal adjustment had been apparent for some time, long before the higher defense spending associated with the escalation of the security problem. Unfortunately, the latter fact only made a reassessment of expenditure priorities and for action to reduce and control nonsecurity expenditures all the more urgent. In the circumstances, it was encouraging that the authorities had recognized the need for drastic action and were planning a cut in the deficit equivalent to 3 percent of GDP. If they succeeded--and he was pleased to note from Mr. Jayawardena that they were more or less on track--the achievement would be a major one. However, the authorities must stand ready to take offsetting action if the budget began to go off track.

On the revenue side, the room for substantial increases in the short term was limited, Mr. Fox commented. Over the longer term, however, action to widen the tax base and improve tax administration--recommendations put forward by the staff mission from the Fiscal Affairs Department--would make an important contribution to the fiscal effort. The only course for the short term must be stricter expenditure control. Given the pressure on expenditure and the potential for substantial overspending, particularly on defense, an even greater effort to cut nondefense spending would be needed. Improved data on public enterprises was also essential if the operations of those enterprises were to be monitored adequately and if consistency with the authorities' overall macroeconomic objectives was to be assured. Considerable scope appeared to exist for manpower cuts both in the Central Government and in the public enterprises, and the World Bank should be able to advise the authorities on how best to carry out those cuts quickly and efficiently. Action to curb widespread subsidies also seemed appropriate. In the area of expenditure control, the decision to limit supplementary appropriations and to control lending on advance accounts was welcome.

Despite a fairly sharp pickup in inflation--from approximately zero in 1985 to a projected 7 percent in 1986--the target for M2 was being kept unchanged, Mr. Fox observed. He would welcome staff comment on the appropriateness of the stance of monetary policy in light of the projected increase in the rate of inflation. More generally in the monetary area, he urged the authorities to implement the findings of the Central Banking Department study by eliminating the subsidy to the National Savings Bank and pricing government debt at market rates.

On the external front, the need to reduce the current deficit from its present high level would clearly prejudice the authorities' ambitions for growth if the reduction were to be achieved through a restriction of imports, Mr. Fox remarked. The growth rate embodied in the staff's medium-term projections already relied on a decline in the capital output ratio and the import intensity of growth, both of which might be optimistic.

The outlook was further clouded by continued commodity price fluctuations and the likely reduction in foreign transfers to Sri Lanka as workers returned from the Middle East. Those developments, together with the need to avoid excessive commercial borrowing, highlighted the necessity for strong action to enhance exports. The various measures to liberalize trade and promote exports taken during recent years were therefore welcome; however, he shared the staff's concern about whether those measures would be sufficient to achieve, for example, the 9 percent growth of nontraditional exports assumed in the medium-term projections. Active use of the exchange rate might well be needed in addition. He welcomed the recent reversal of the trend of deteriorating competitiveness brought about by the nominal depreciation of the rupee, and he urged the authorities to consider further depreciation.

Despite the considerable progress Sri Lanka had made in recent years, particularly in the structural area, the immediate economic prospects were worrying, Mr. Fox said. The authorities had begun to take action to reduce the fiscal deficit to a more sustainable level, and he had taken note of their intention to present economic and fiscal policies over a three-year period in the forthcoming budget. He urged them to take the opportunity of the budget discussions to intensify the fiscal effort and set the fiscal deficit on a decisively downward trend. On the external front, the process of trade liberalization would need to be buttressed by continued flexible management of the exchange rate to maintain and improve competitiveness; and those policies would need to be supported by a firm monetary policy. In all areas, the authorities should follow closely the advice in the staff appraisal. Finally, he could support the proposed decision.

Mr. Polak observed that while economic growth had been sustained in Sri Lanka in 1985 at about 5 percent in real terms and inflation had been reduced to zero, economic policymaking had clearly suffered a setback. The overall fiscal deficit had increased from 8.9 percent of GNP to 14.3 percent of GNP, reversing the trend of recent years; and the current account deficit had more than doubled. As a consequence, gross official reserves had declined to the equivalent of 2.5 months of imports, leaving the authorities with little cushion to absorb external shocks.

The unfavorable results of 1985 had been caused partly by factors beyond the control of the authorities: the large drop in the terms of trade--reversing the unexpectedly favorable developments of 1984--and the internal security situation, Mr. Polak continued. However, those factors had been compounded by the authorities' inability to control the major budget aggregates. The medium-term outlook, while indicating that the situation could remain manageable, also showed that for the future there was little scope for dealing with unfavorable developments, especially as the debt service ratio would remain on the high side. Against that background, it should perhaps be recalled that both Sri Lanka and the Fund had invested a great deal in Sri Lanka's adjustment effort over the past years. That effort had borne some important fruits, bringing about a more rational and liberal economy, lessening dependence on imports and raising the country's growth rates. Clearly, the effort should serve as the basis for further movement in the same direction.

The staff had rightly stressed that the core of Sri Lanka's current economic problems was the fiscal situation, Mr. Polak recalled. While the authorities' budget plans called for a reduction in the deficit from 14 percent of GNP in 1985 to 11.5 percent in 1986, he believed that more should be done to contain spending, raise revenue, and make the tax system more efficient. In the area of government expenditure, important steps had been taken--including a closure of some state enterprises and restraints on the spending departments--but current expenditure would still remain high by comparison with that in previous years. There would be very little decline in household subsidies and significant increases were foreseen both in the total wage bill and in subsidies to public corporations. He fully agreed with the staff's observation that large savings could be achieved by streamlining the public sector; in that context, he questioned the government guarantee in the development of the sugar company, especially since the costs to the Government were high by comparison with world market prices, and the guarantee could give rise to future budgetary problems for Sri Lanka while damaging other Third World sugar producers.

The authorities' decision to allow tax revenue to decline was unfortunate, Mr. Polak considered. Even after an upward adjustment in the course of 1986, revenue in relation to GNP was expected to be a full percentage point lower than in 1985. While accepting that it was important to reduce dependence on export taxes, he believed that that reduction should be offset by increasing revenue from other sources, since the deficit was still quite large. He shared the staff's view, moreover, that an increased effort to raise revenue to compensate for increased defense outlays seemed warranted, and he could support the observation that savings could be generated by making the tax system more efficient.

The increase in the budget deficit had had significant consequences for monetary policy in Sri Lanka, Mr. Polak noted. The authorities had recourse to several forms of administrative controls and, while he concurred with the overall targets for monetary policy for 1986, he urged the authorities to rely more on market-related instruments to achieve them. Such an approach would include the abolishment of the subsidy paid to the National Savings Bank. He welcomed the efforts of the mission from the Fund's Central Banking Department to help Sri Lanka open up competition in its financial markets; and he questioned the compatibility of the objectives of increasing competition among banks and the imposition of credit ceilings and a still further increase in reserve requirements. Finally, on the exchange rate, he agreed with the staff on the need for flexibility. However, flexibility in the management of the exchange rate would be effective only if the inflationary consequences could be kept under control. In that respect, the increase in 1985 in real wages and the pressure for wage increases in the public sector were a matter of concern. There was a clear need to check those pressures; and, if there were to be an exchange rate adjustment, it must be accompanied by greater wage moderation to be effective.

Mr. Grosche, noting that he was in broad agreement with the staff's analysis and recommendations, remarked that the improvements recorded in Sri Lanka's economy in past years had been sharply reversed in 1985 in some key areas. Both external and domestic factors, including security problems, were to be blamed for that development. There was no doubt that the sharp increase in Sri Lanka's imbalances experienced in 1985 had to be addressed in a determined and comprehensive way. The initial measures adopted by the authorities in 1985 fell short of what was required. The staff had clearly spelled out the policy areas in which comprehensive corrective measures were most urgently needed. Those included steps in the fiscal area as well as in external policies and infrastructure. He was pleased to note that the authorities fully agreed on the need for corrective action and that their basic policy orientation for 1986 was a step in the right direction. However, he had some doubts about whether the measures envisaged to achieve the needed reduction of internal and external imbalances were sufficient. It was also doubtful whether the authorities' targets--particularly those in the fiscal area--could be achieved. Past experience with expenditure control was not encouraging, and there were indications that expenditures in 1986, at least in some important areas, would be higher than originally targeted.

The envisaged reduction in the fiscal deficit should come mainly from expenditure restraint, Mr. Grosche remarked, although some emphasis should also be placed on an increase in revenues. He noted that the authorities had already introduced a number of revenue-raising measures, although they were not in his view sufficient. In particular, efforts should be made to broaden the tax base and improve tax administration. Moreover, a lasting improvement of the fiscal position could be expected only if the existing structural weaknesses in the public sector--including those in the public enterprises--were overcome. A fundamental reform effort appeared warranted, and he hoped that the work of the Administrative Reform Committee would prove a first step in the right direction. Efforts should also be strengthened to resolve the ongoing financial problems of many public enterprises.

With regard to external sector policies, Mr. Grosche indicated that he shared the staff's concerns about the medium-term prospects. The projections clearly underlined the need to strengthen the adjustment effort and to tackle the structural weaknesses of the economy in order to generate a better export performance in future. While welcoming the initiatives of the authorities to strengthen the external sector in the recent past, he felt that more needed to be done. Additional steps should be taken to diversify the narrow export base and, in that context, the exchange rate had a major role to play. Noting that the real exchange rate had moved in the appropriate direction in 1985, he felt that a further adjustment was needed, since the sharp appreciation of the real exchange rate experienced between 1980 and 1984 had been reversed only minimally in 1985. In conclusion, he could support the proposed decision.

Mr. Rye observed that, in taking account of the substantial progress made since the late 1970s in the Sri Lanka economy, the staff had rightly observed that developments in 1985 highlighted the structural weaknesses of the economy, particularly high government spending, inadequate expenditure control, and insufficient diversification and expansion of the export base. Comments by Directors made during the Executive Board discussion of the 1985 Article IV consultation with Sri Lanka remained relevant: reform of the tax system was needed to strengthen private sector incentives and to broaden the tax base; fiscal control procedures must be made more effective; and the efficiency of the public enterprises needed to be enhanced. It was clear that the authorities were fully aware of what needed to be done, but implementation of the appropriate measures left something to be desired. The authorities were constrained by problems of national security in some areas; however, where they could exercise sufficient control, the adjustment effort seemed inadequate. Hence, in spite of the closure of some public corporations and of unprofitable units of others, advances to inefficient and unprofitable public enterprises continued to strain the public finances, and exemptions and exclusions continued to weaken the tax system.

While the measures already adopted by the authorities and described on pages 13-14 of the staff report were steps in the right direction, implementation should be more consistent and rigorous than it had been to date, Mr. Rye continued. An example highlighted by the staff was "the need to consider supplementary provisions early in 1985 [which] reflected weaknesses in budget policy and formulation."

As in the fiscal area, the targets on the monetary side seemed consistent with the authorities' budget and with policies regarding the role of the private sector, Mr. Rye commented. Of course, success on the monetary side would depend on how rigorously the authorities were able to adhere to the budget. While agreeing with the staff that it was desirable to eliminate credit ceilings, he believed that their use for nonessential imports could be tolerated until a reform of the system was effected, especially since the overall level of credit to the private sector was not constrained. Besides, credit ceilings had been effective in restraining imports of nonessentials, although it would be more appropriate to use the exchange rate mechanism and a reasonable level of customs duties to achieve the same goals. He urged the authorities in any event to establish a broader market orientation in the financial system. The recommendation by the Central Banking Department mission to eliminate the subsidy to the National Savings Bank was appropriate and, indeed, essential to any program aimed at increasing the role of market forces in the determination of interest rates. Of course, the elimination of the subsidy would also have a beneficial impact on the fiscal side.

The authorities should be commended for maintaining their commitment to trade liberalization, Mr. Rye considered. As with other developing countries, Sri Lanka's exports, particularly in the nontraditional sector, had been impeded by protectionist practices in Sri Lanka's major trading partners. Also, the authorities' assurances of flexibility in the management of the exchange rate were welcome.

He agreed with the staff that, in the medium term, there was little scope for the Sri Lanka economy to absorb potentially large downside risks, particularly given the relatively poor outlook for exports and the increased need for commercial borrowing, Mr. Rye said. Debt service trends, especially beyond 1990, were cause for concern, and he urged greater rigor in the authorities' adjustment efforts and greater consistency in the push toward export orientation and diversification, greater responsibility through expenditure control, and a broader and more elastic tax system and administration. He recommended additional caution in debt management and stressed the importance of exchange rate flexibility, given the need for export sector development. He was pleased to note from Mr. Jayawardena that the Sri Lanka authorities were determined to adjust economic policies and practices to the difficulties that had emerged in the economy in the past year. Their determination encouraged optimism. In conclusion, he could support the proposed decision.

Mr. Dallara observed that despite the difficult security situation and the economy's continuing vulnerability to changes in world commodity markets, Sri Lanka had managed to sustain a relatively high rate of growth in 1985, while inflation had dropped sharply. In addition, the authorities had made further progress in implementing basic structural reforms, including the closure of some loss-making public enterprises. Unfortunately, existing and potential domestic financial imbalances, together with structural weaknesses in the economy, suggested that the recent growth and inflation performance might not be sustainable over the medium term without strong action to address both fiscal and structural problems. In that regard, while the external debt-servicing burden might appear at present to be relatively manageable, note should be taken that it had grown rapidly of late, reaching 24 percent of current receipts in 1986.

The problems and prospects of the Sri Lanka economy became even clearer when viewed in a medium-term context, Mr. Dallara continued. In that respect, the data and analysis provided by the staff had been helpful. With tea prices relatively weak, the 1986 current account deficit could be significantly higher than earlier projected, and it appeared that large financing gaps could emerge in 1987 and 1988, since the scope for reduction of imports appeared limited if growth objectives were to be achieved. Moreover, remittances were projected to decline. Those projections pointed to the need for a substantial strengthening of the adjustment effort and the adoption of policies related to export growth.

Clearly, if export growth was to be achieved, important progress would need to be made in the fiscal area to free up resources for the private sector, Mr. Dallara remarked. The fiscal deficit had reached nearly 12 percent of GDP in 1985, after grants, due in large part to the expenditure overruns that had occurred in several areas. Reducing the deficit to 9 percent of GDP in 1986, as hoped, would still leave the deficit on the high side, in his view, given the medium-term objectives of the authorities. Several steps had been taken to contain and reduce the deficit in relation to its size in 1985, including a number of steps to gain further control over expenditures. Nevertheless, it remained unclear whether the fiscal effort for 1986 would be adequate and whether sufficient controls were in place to ensure that the outcome was commensurate with the government targets. Like other Directors, he had noted that the authorities had found it necessary to increase some areas of current spending in 1986 beyond what was originally provided for in the budget. In his view, it would have been appropriate to compensate for those increases by simultaneously reducing spending in other priority areas. Instead, increases had occurred in nonsecurity-related expenditures that had not been fully offset by spending cuts or further revenue-raising measures. In that connection, he joined other Directors in welcoming the contingency elements envisaged in the forthcoming three-year budget presentation. In present circumstances, contingency plans could be particularly helpful; however, he wondered whether implementation of those elements would be sufficiently timely to deal with the problems that could arise in the course of 1986, especially since some further action was already warranted to contain the fiscal position.

He welcomed the progress made in reducing subsidies and noted with interest the steps taken by the authorities to reform the food stamp program to ensure that the truly needy were helped, Mr. Dallara commented. Perhaps Sri Lanka's experience in that area would be relevant for other countries attempting to reform their low-income support programs. Efforts should be made to reduce the drain those programs placed on the budget while still ensuring that some of the essential social objectives of the programs were achieved. He also welcomed the authorities' decision to grant no cost of living wage increases to civil servants in 1986. In general, his preference was for greater expenditure control--given the basically healthy private economy--and the preservation of incentives. In that regard, the reduction in export taxes was a welcome step, although he was left wondering whether a more general tax reform effort might not help the authorities to achieve their medium-term objectives.

He had noted with interest that a recent technical assistance mission from the Fiscal Affairs Department in the Fund had reviewed fiscal matters with the authorities in 1985 and an expert had recently been sent to Sri Lanka to advise the authorities on issues and problems in tax administration, Mr. Dallara said. He would welcome any additional information that Mr. Jayawardena or the staff might provide on the mission's work, especially since a more comprehensive tax reform effort would be worth considering in the present difficult circumstances--both external and internal--faced by the Sri Lanka economy. He had the impression that some of the revenue measures taken recently to contain the fiscal position were not part of an overall consistent approach toward tax administration.

Concern had been expressed by some of his colleagues that performance in the public enterprises might weaken in 1986, requiring additional support from the Government, Mr. Dallara recalled. Such additional support could be required despite the laudable steps taken in 1985 to close a number of unprofitable enterprises. The problem appeared to be one of containing costs related to inefficiencies and overstaffing rather than inadequate price levels in general. In that respect, privatization could further introduce the incentive to increase efficiency in the economy, and he urged the authorities to consider additional steps toward privatization and a strengthening of the efficiency of the remaining public enterprises. Such an approach was necessary in the establishment of an industrial policy that, in and of itself, seemed essential to the export objectives of the authorities.

Remarking on monetary policy, Mr. Dallara considered it somewhat unusual that there had been little decline in interest rates on loans in the face of excess liquidity in the banking system and low inflation. The recently completed report of an IMF technical assistance mission appeared to address various structural problems in the banking and credit system; he would appreciate hearing from Mr. Jayawardena or the staff some indication of when and how the authorities might act to implement the recommendations in that report.

Like others, he had taken note of the depreciation of the exchange rate in 1986 and of the indication that comparative costs at present were not grossly out of line, Mr. Dallara went on. Nonetheless, the export sector was not growing at a rate compatible with its potential, and the medium-term payments prospects would seem to argue for a stronger reserve position as well as additional exchange rate adjustment.

He would welcome any information the staff or Mr. Jayawardena might provide on the role of the World Bank in Sri Lanka, Mr. Dallara said. The section of the staff paper describing the World Bank's role was rather less than comprehensive, and it was unclear from the tables and the text whether any program-related efforts were in fact under way in Sri Lanka or whether only project lending was going on. Given the serious structural problems remaining in Sri Lanka and the interest of the authorities in further liberalizing their economy, there would seem to be considerable scope for World Bank support for further policy changes in that area.

Sri Lanka had maintained an open payments system over the past decade that, together with other liberalization measures, had contributed to an underlying strengthening of the economy, Mr. Dallara commented. To take advantage of that strength and to consolidate it, economic policies in a number of areas must be tightened so that a more diversified and rapidly growing export base could be generated. In sum, therefore, the authorities needed to make a stronger effort in the fiscal and structural areas to achieve the export targets that were critical to the overall growth objectives for the medium term.

Mr. Chatah observed that, in a number of important respects, the performance of the Sri Lanka economy had been relatively good over the past few years, with the rate of growth having remained at about 5 percent, irrespective of the fluctuations in other areas of economic performance. There was no doubt, however, that the robust growth rate of the past could not be maintained indefinitely along with financial stability unless the underlying financial and structural weaknesses of the economy were dealt with effectively. As Mr. Jayawardena had emphasized in his statement, important and positive changes had taken place in the Sri Lanka economy over the past decade that should place the authorities in a better position to address some of the long-standing problems that had the potential to jeopardize the significant progress already made. While the economy appeared to be in a position to withstand for some time the underlying pressures--aided by access to international capital markets--it was crucial that steps be taken to reduce those pressures at a time when the position of the economy and the available margin for maneuver were both advantageous.

Although from a short-term perspective an increase in fiscal revenue might appear desirable, the basic fiscal problem faced by the Sri Lanka authorities did not lie so much with inadequate revenues--which as a percentage of GDP were not particularly low--as with control of expenditures, Mr. Chatah went on. There was a problem in the structure of revenues, which might not have a direct bearing on the fiscal deficit as such but was certainly important for the other economic objectives of the authorities. He was referring in particular to the tax and tariff systems, which appeared to hinder the authorities' drive to promote private sector investment and exports and to improve economic efficiency in general. The measures adopted recently were welcome, although a more comprehensive approach was still needed. On the expenditure side, the authorities clearly recognized the need for tighter control. The 1986 budget went some way toward that objective, and the projected reduction in expenditure from 35.5 percent to 31 percent of GDP, if achieved, would constitute a substantial step toward restoring fiscal balance. However, it was important that the expenditure control effort be sustained beyond 1986 and that a comprehensive reform of the public enterprise sector be adopted. In that regard, he welcomed the authorities' intention to present in the forthcoming budget a framework of economic and fiscal policies over a three-year period, a move that should help to enhance private sector confidence in the authorities' medium-term objectives and policies.

Monetary policy in 1985 had played an important role in containing the impact of the rise in the fiscal deficit, Mr. Chatah observed. However, there was a limit to how much monetary policy could offset the negative effects of the fiscal imbalance. Despite the monetary restraint in 1985, GDP growth had been maintained at 5 percent, but that outcome--which had been accompanied by zero or even negative inflation--might not be sustainable. The apparent increase in the demand for liquid assets, perhaps associated with the security situation, might have masked the monetary impact of the deficit, but the situation could change significantly over the immediate future, which would make the impact of the fiscal deficit more apparent. Moreover, the monetary response had contributed to excessive real interest rate levels, and he wondered whether GDP growth could proceed at the same pace indefinitely at such high interest rates. It seemed inevitable that private sector investment and export profitability would be hindered by excessive interest costs. One of the curious reasons given by the staff for the high lending rates was the fact that the two dominant banks were government owned; however, whatever the reason, it seemed desirable that lending interest rates should be lowered, preferably through the market mechanism, and that the banking system should be made more flexible. In that regard, collaboration between Sri Lanka and the Fund would be welcome.

It was obvious that the external imbalance in Sri Lanka was basically structural in nature, Mr. Chatah said. Import compression and external commercial borrowing could be--and, indeed, had been--used to contain the implications of the underlying weakness in the balance of payments. Eventually, however, in order for the external financial balance to be maintained while avoiding an undesirable acceleration in the debt service requirement and maintaining a healthy growth rate, exports would have to increase in a steady and sustained manner. It followed, therefore, that measures to promote and broaden the export sector should receive priority. He had taken note of the balance of payments projections in the staff report and the analysis on page 24 of the report of the consistency of objectives and assumptions underlying the medium-term scenario. The staff had estimated that the achievement of the growth and balance of payments targets over the medium term would imply a 15 percent annual nominal increase in nontraditional exports until 1990. In the staff's view, such a rate would "seem well within Sri Lanka's reach, provided a supportive policy framework is established and maintained." As he had mentioned earlier, the authorities should do their part in creating the domestic environment that would be conducive to an improvement in the export sector, including nontraditional exports. Clearly, however, the promotion of such exports would be hindered--if not rendered useless--by the protectionist barriers erected against them. It would be unfortunate if the efforts of the authorities over the past decade to realize Sri Lanka's growth and export potential through a general policy of economic liberalization were to be frustrated by the protectionist policies of Sri Lanka's main trading partners.

The Executive Directors agreed to continue their discussion at 3:00 p.m.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/108 (7/2/86) and EBM/86/109 (7/7/86).

4. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 85/165 are approved. (EBD/86/177, 6/26/86)

Adopted July 2, 1986

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/158 (7/1/86) and EBAP/86/160 (7/2/86), and by an Assistant to Executive Director as set forth in EBAP/86/159 (7/1/86) is approved.

APPROVED: March 26, 1987

LEO VAN HOUTVEN
Secretary