FOR AGENDA

SM/85/101

CONTAINS CONFIDENTIAL INFORMATION

April 9, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Sri Lanka - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Sri Lanka, which will be brought to the agenda for discussion on a date to be announced. A draft decision appears on page 26.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Szapary (ext. 7365) or Mr. De Wulf (ext. 7343).

Att: (1)

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INTERNATIONAL MONETARY FUND

SRI LANKA

Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the
1985 Consultation with Sri Lanka

Approved by Tun Thin and Eduard Brau

April 8, 1985

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The 1985 Article IV consultation discussions with Sri Lanka were held in Colombo during February 11-22, 1985. Discussions were held with Mr. de Mel, Minister of Finance and Planning; Mr. Fernando, Minister of Industry and Scientific Affairs; Mr. Jayewickreme, Minister of Public Administration and of Plantation Industries; Dr. Rasaputra, Governor of the Central Bank of Ceylon; Dr. Tilakaratna, Permanent Secretary of Finance and Planning; and other senior officials. The staff team consisted of Messrs. Szapary, De Wulf, Feldman, Broadway (all ASD), Feltenstein (FAD), Maciejewski (ETR), and Miss Yeong (ADM). Mr. Rajapakse from the IBRD office in Colombo participated in most of the meetings as observer. Mr. Mountford, Resident Representative of the Fund, assisted the mission. Mr. Jayawardena, Alternate Executive Director for Sri Lanka, participated in some of the discussions as observer.

Sri Lanka continues to avail itself of the transitional arrangements of Article XIV.

I. Background

The liberalization reforms of 1977-78 heralded a new era of economic policy and marked a turning point in the economic performance of Sri Lanka. By reducing administrative controls, establishing more realistic relative prices, introducing major tax and interest rate reforms, dismantling the trade and payments restrictions, and unifying the exchange rate at a depreciated level, the authorities restored vitality to an economy previously characterized by slow growth and high unemployment. The results achieved following the reforms were quite remarkable: real GDP rose by an average of 6 percent per year during 1978-84, compared with 3 percent during 1970-77 (Table 1), and the unemployment rate fell from well over 20 percent in the mid-1970s to about 12 percent in 1984. Responding to the new incentives, private investment increased significantly, especially in the areas of transportation, tourism, and the export-oriented garment industry. Simultaneously, the Government undertook an ambitious investment program, centering on the Mahaweli development program. Although the full implementation of this program is still several years away, the major works have already been completed. The benefits of the program are expected to be substantial, particularly in the form of increased irrigation and domestic energy

Table 1. Sri Lanka: Major Trends in the Economy, 1970-84

(In percent of GDP unless otherwise specified)

	1970-77 Annual Average	1978	1979	1980	1981	1982	1983	1984	1978-84 Annual Average
Investment 1/	16.0	20.0	25.8	33.8	27.8	30.6	28.6	26.1	27.5
Public 2/	7.7	11.1	12.6	20.1	14.8	18.6	17.0	16.3 3/	15.8
Private	8.3	9.0	13.2	13.7	13.0	12.0	11.6	9.8 3/	11.8
Domestic savings	12.7	15.5	14.7	14.0	14.0	15.4	16.2	22.5	16.0
Public 4/	...	-1.3	0.4	-3.6	-1.8	-1.4	0.2	3.5	-0.6
Private 2/	...	16.8	14.3	17.6	15.8	16.8	16.0	19.0	16.6
Foreign savings	3.3	4.5	11.1	19.8	13.8	15.2	12.4	3.6	11.5
Terms of trade (percentage change)	...	-7.1	-10.5	-12.1	-6.9	-2.4	18.0	18.7	-3.3
External debt	...	37.4	42.3	46.9	52.3	55.7	58.4	52.0 3/	49.3
Export volume (percentage change)	...	7.1	-8.1	-5.1	9.1	4.4	-6.6	18.8 3/	2.8
Real GDP (percentage change)	2.9	8.2	6.3	5.8	5.8	5.1	5.0	5.0	5.9
Inflation (percentage change) 5/									
Annual average	...	8.8	19.0	37.7	23.9	11.0	11.3	16.8	18.3
December to December	...	13.7	31.8	28.2	23.5	1.4	22.0	6.7	18.2

Sources: Data provided by the Sri Lanka authorities; and staff estimates.

1/ Including change in stocks.
2/ Including public corporations.
3/ Estimate.
4/ Central Government only.
5/ Cost of living index of the Central Bank.

supply. 1/ Although per capita income is still modest, Sri Lanka can pride itself on the relatively high quality of life enjoyed by its people as characterized by low infant mortality, high life expectancy, and high literacy.

Along with the success, however, developments since 1977 have also revealed two important weaknesses which have long-term implications: (i) a lack of growth of domestic savings to support a satisfactory level of investment; and (ii) an inadequate growth of exports to ensure sustained rapid economic growth with a viable balance of payments.

Domestic savings, after an initial rise in 1978, remained at 14-16 percent of GDP through 1983 (Chart 1), registering a marked increase only in 1984 as a result of a sharp improvement in the external terms of trade. The poor savings performance was partly a reflection of the continuous deterioration of the terms of trade during 1978-82, which adversely affected government revenue and real incomes. However, inadequate progress in expanding the domestic revenue base and improving the financial position of public enterprises were also important contributing factors. Furthermore, as rates of inflation remained high, real interest rates were negative over an extended period of time.

The slow growth of exports has been the combined result of a prolonged neglect of the tree-crop sector (tea, rubber, coconuts) stemming from the nationalization of plantations, and an inadequate framework of incentives to encourage a dynamic export-oriented manufacturing industry. The weaknesses in the incentive framework have included an exchange rate policy that has been characterized by insufficient flexibility and a structure of effective protection that has introduced a bias against exports. This situation has encouraged investment in trade, construction, real estate, and inefficient import substitution rather than investment in exports. Other factors, such as lack of knowledge of foreign markets and limited entrepreneurship, have also hampered the development of nontraditional exports.

1/ The Mahaweli scheme is a large-scale hydropower and irrigation program centering on a series of dams. Implementation of the scheme is expected to have a significant impact on the balance of payments over the medium term through reducing the dependence on oil imports as a source of power generation, increasing self-sufficiency in food, and developing minor crops for exports. Employment will also increase through settlements on previously uncultivated land. A total of 130,000 acres of land are to be irrigated, of which 100,000 acres will be on previously uncultivated land. The pace of this irrigation program is expected to be 20,000 acres per year. Foreign financing has been critical to the projects, with about 75 percent of total funding coming from abroad in the form of concessional aid.

The virtual stagnation of domestic savings, combined with a high level of investment, led to pressures on domestic prices and a growing reliance on foreign savings. Initially, most of the external capital inflow was in the form of grants and concessional aid as the donor community responded favorably to government efforts to strengthen the economy. However, when the world economy deteriorated in the early 1980s, Sri Lanka began to make increasing use of external borrowing on commercial terms. By 1983, the amount of outstanding external debt had increased to almost 60 percent of GDP--of which one third represented borrowing on commercial terms--and the external debt service payments had reached 24 percent of exports of goods and services.

In sum, Sri Lanka has achieved considerable economic and social progress in the last several years. However, the development potential remains constrained by the weak domestic savings effort and a narrow export base. Another emerging constraint on the development of the economy is the ethnic conflict which has led, inter alia, to an increase in defense expenditure, a fall in tourism, and a deterioration in the investment climate.

II. Developments in 1984

1. Overview

A dominant feature of the economic scene in Sri Lanka in 1984 was the continued high level of tea prices; 1/ rubber and coconuts prices were also, on average, more favorable. In recognition that tea prices were cyclically high, one of the principal objectives of the authorities was to accumulate reserves while reducing foreign commercial indebtedness. At the same time, the authorities sought to ensure that the balance of payments surplus would not jeopardize the objective of bringing inflation under control.

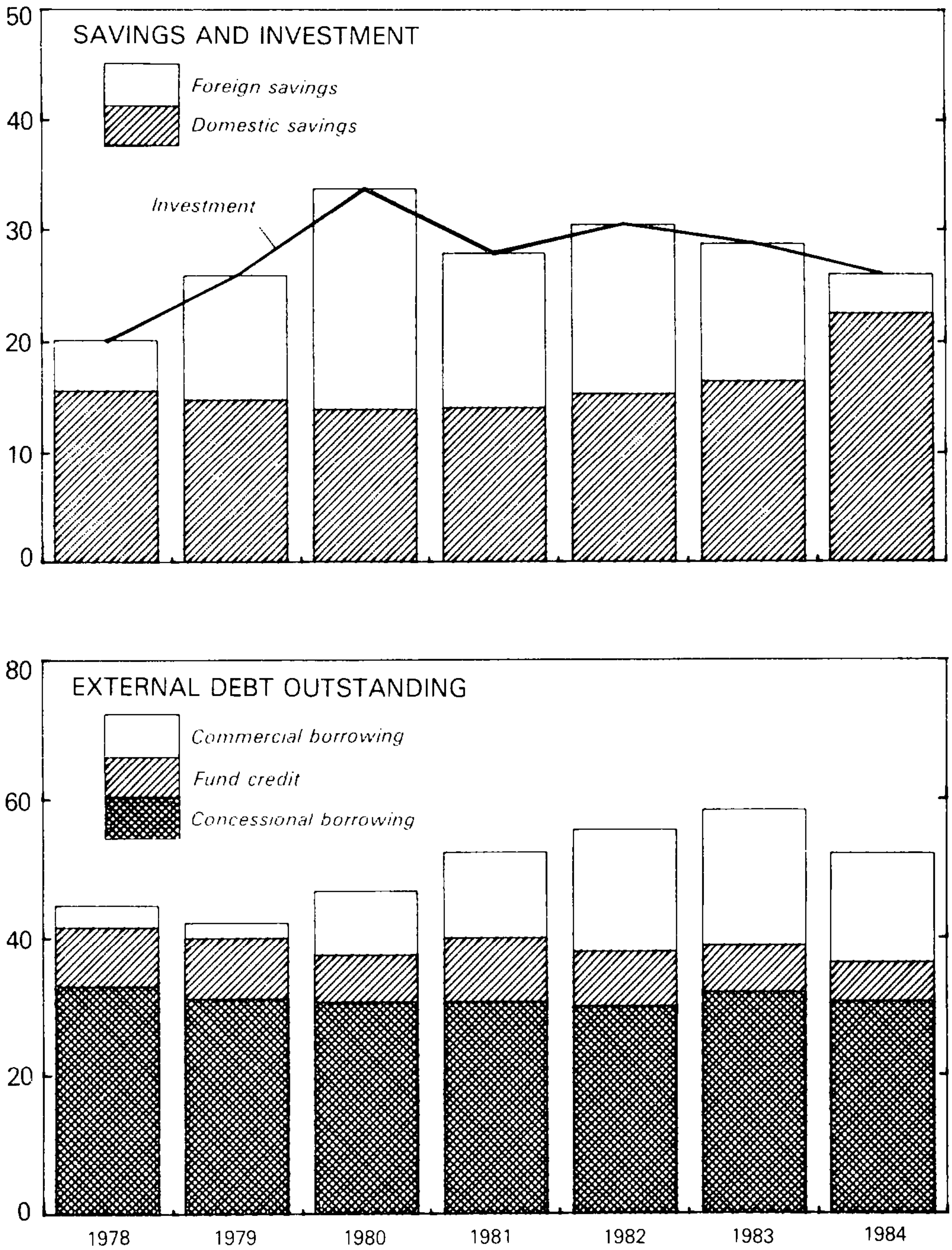
1/ World tea prices began a strong upward movement in the second half of 1983, reaching a peak in January 1984. Subsequently, they declined through July, but resumed an upward trend during the remainder of 1984. As a result, Sri Lanka's average export price for tea was more than 40 percent higher in 1984 than the year before. Essentially, the rise in prices reflected the combined outcome of (i) steadily increasing world demand, particularly in India and other Asian countries where the income elasticity of the demand for tea is relatively high; and (ii) a slow growth of world production, especially in 1983 when output in Sri Lanka and India was affected by drought. For further details on developments in world tea prices, see Annex I in the associated Recent Economic Developments report to be issued shortly.

CHART 1

SRI LANKA

SAVINGS, INVESTMENT AND EXTERNAL DEBT OUTSTANDING, 1978-84

(In percent of GDP)



Sources: Data provided by the Sri Lanka authorities and staff estimates.

The authorities recorded some notable successes in these areas. Foreign exchange reserves were increased considerably, external short-term borrowing was reduced, and significant progress was made in lowering the domestic rate of inflation (Table 2). The Government also took some important measures to deal with the more fundamental weaknesses of the economy, including steps toward rehabilitating the state plantation sector and a tariff reform designed to reduce effective protection. But developments during 1984 also brought to the fore some serious weaknesses in policies; in particular, a lack of expenditure control and the continued poor performance of many public enterprises resulted in a government budget deficit considerably higher than envisaged a year earlier. In addition, external competitiveness was eroded further because of a lack of exchange rate flexibility.

2. External developments

With export receipts increasing by 45 percent and imports growing only moderately, the external current account deficit declined from over 12 percent of GDP in 1983 to less than 4 percent in 1984 (Table 3). About half of this improvement was the consequence of an increase in Sri Lanka's terms of trade. 1/ The remainder came essentially from the recovery of tea output from its drought-stricken level of 1983 and a strong performance of garment exports. On the other hand, nontraditional exports other than garments recorded only a modest growth. The growth of imports was contained mainly by restrictive credit policy, greater self-sufficiency in food, and a fall in the world prices of certain imported food items (e.g., sugar).

The other main elements of the current account, namely, tourism and workers' remittances, recorded little change in 1984. Earnings from tourism increased only slightly, as tourist arrivals dropped for the second year in a row, mostly due to the unsettled security situation. Workers' remittances showed only a small growth, reflecting the weakened economic activity in the Middle East. Still, the continued rise in workers' remittances to Sri Lanka contrasts with the decline in such remittances experienced by other countries in the region. The authorities attribute this to the generally higher level of education of Sri Lanka workers which makes them suitable for jobs that are less sensitive to fluctuations in economic conditions.

1/ In 1984, Sri Lanka's terms of trade improved by close to 20 percent, representing an estimated gain in the trade account equivalent to more than 4 percent of GDP. This was the second consecutive year that Sri Lanka benefited from such an improvement in the terms of trade, bringing the cumulative gains in the trade account due to terms of trade increases to the equivalent of about 8.5 percent of GDP during 1983-84.

Table 2. Sri Lanka: Selected Economic and Financial Indicators, 1981-85

	1981	1982	1983	1984	1985 Proj
			(Changes in percent)		
Real GDP	5.8	5.1	5.0	5.0	5.0
GDP deflator	20.5	9.9	16.0	19.0	8.0
Consumer prices					
Annual average	23.7	11.0	11.3	16.8	...
End of period	23.5	1.4	22.0	6.7	...
Export volume	9.1	4.4	-6.6	18.8	1.7
Import volume	-10.1	18.9	1.1	-0.3	2.4
Terms of trade	-6.9	-2.4	18.0	18.7	-4.6
Effective exchange rate 1/ (depreciation -)					
Nominal	-3.5	5.4	-11.0	3.6	...
Real (adjusted WPI)	13.0	-2.0	-2.3	6.2	...
Real (CPI)	10.0	2.5	4.2	6.4	...
Budget revenue	15.1	8.9	43.1	44.5	6.7
Budget expenditure and net lending	-0.2	19.0	18.2	24.2	9.3
Net domestic credit 2/	32.7	25.1	16.5	0.9	...
Government (net)	41.6	33.7	2.3	-17.2	...
Private sector	34.0	24.1	33.8	13.7	...
Broad money 2/	23.2	24.5	21.7	16.8	...
			(In percent of GDP)		
Budget					
Deficit before grants	15.6	17.2	13.3	10.2	10.3
Deficit after grants	12.4	13.8	10.5	7.4	8.2
Revenue	18.0	16.6	18.9	21.8	20.5
Expenditure	33.5	33.8	32.2	32.0	30.8
Domestic financing	6.6	9.1	5.3	1.7	3.3
Current account deficit, excluding grants	-13.8	-15.2	-12.4	-3.6	-4.9
Current account deficit, including grants	-10.2	-11.8	-9.1	-1.1	-2.7
External debt	52.3	55.7	58.4	52.0	54.5
Debt service 3/ as percent of:					
Exports of goods and services	19.3	22.4	24.4	17.4	20.6
Current account receipts	16.6	18.4	20.2	14.9	17.5
			(In millions of SDRs)		
Exports	903	918	993	1,439	1,433
Imports	-1,597	-1,808	-1,794	-1,864	-1,949
Current account	-517	-663	-602	-215	-310
Overall balance	-26	-18	--	297	281
Gross official reserves (months of imports)	1.9	2.1	2.0	3.4	4.7
External debt 4/	1,958	2,426	2,833	3.060	3,441
Debt service payments 3/	226	273	321	307	368

Sources: Data provided by the Sri Lanka authorities; and staff estimates.

1/ December average over December average.
2/ End-December to end-December.
3/ Including interest payments on short-term debt, progress payments, and Fund charges and repurchases.
4/ Including Fund credit.

Table 3. Sri Lanka: Balance of Payments, 1982-85

	1982	1983	1984 Prel.	1985 Official Proj.
		(In millions of SDRs)		
A. Trade account	-890	-801	-425	-516
Exports, f.o.b.	918	993	1,439	1,433
Imports, c.i.f.	-1,808	-1,794	-1,864	-1,949
B. Services, net	-13	-57	-60	-67
Of which: travel receipts	(117)	(96)	(99)	(105)
C. Private transfers, net	240	256	270	273
D. Current account (A+B+C)	-663	-602	-215	-310
E. Official transfers	147	160	150	141
F. Nonmonetary capital, net	478	420	327	450
Direct investment, net	58	35	35	33
Concessional borrowing, net	187	235	283	305
Commercial borrowing, net	233	150	9	112
Central government	50	25	38	23
Private sector	183	125	-29	89
Of which: short-term	(7)	(37)	(-26)	(16)
G. Errors and omissions	20	22	35	--
H. Overall balance	-18	--	297	281
I. Monetary movements				
Gross official reserves (- increase)	-24	18	-230	-245
Use of Fund credit, net	-5	-10	-9	-36
Other	47	-8	-58	--
Memorandum items:				
Official gross reserves at year-end	313	292	522	767
(in months of imports)	(2.1)	(2.0)	(3.4)	(4.7)
		(In percent of GDP)		
Current account deficit	-15.2	-12.4	-3.6	-4.9
Current account deficit, including grants	-11.8	-9.1	-1.1	-2.7
Overall balance (deficit = -)	-0.4	--	5.0	4.5
External debt	55.7	58.4	52.0	54.5
External debt service ratio	22.4	24.4	17.4	20.6

Source: Data provided by the Sri Lanka authorities.

The substantial reduction in the current account deficit, combined with the continued inflow of capital on concessional terms, allowed Sri Lanka to reduce sharply its reliance on external commercial borrowing, to repay a significant amount of short-term debt, 1/ and to increase considerably gross official reserves. The overall balance of payments registered a surplus of almost SDR 300 million (compared with an approximate balance in 1983), and gross official reserves increased to the equivalent of about 3.5 months of imports. Mainly as a result of the sharp increase in export receipts, the debt service ratio fell to 17 percent in 1984.

Since the devaluation of the rupee and the unification of the exchange rate in November 1977, the real effective exchange rate (REER) for the rupee has been continuously appreciating, as successive nominal depreciations of the rupee have been insufficient to compensate for the higher inflation in Sri Lanka than in its trading partners (Chart 2). The cumulative appreciation in the CPI-based REER 2/ has been 45 percent since 1978-79 and 25 percent since 1980. 3/ Between July 1983, when the rupee was depreciated by 5 percent, and February 1985, the real appreciation was 13 percent, as the depreciations of the rupee vis-a-vis the U.S. dollar, the intervention currency, were not sufficient to correct for the strength of the dollar and the higher rate of inflation in Sri Lanka.

3. Fiscal developments

The budget deficit (before grants) was reduced substantially for the second consecutive year, from the equivalent of over 13 percent of GDP in 1983 to about 10 percent in 1984 (Table 4). Thus, over the two-year period 1983-84, the deficit shrank by the equivalent of approximately 7 percentage points of GDP. As in 1983, the reduction in 1984 came about through a combination of higher revenue and expenditure restraint. The increase in revenue in 1984 was the outcome of higher

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1/ Gross disbursements on commercial loans fell from SDR 232 million in 1983 to SDR 85 million in 1984, and the amount of outstanding short-term debt declined by over SDR 70 million to SDR 230 million (4 percent of GDP).

2/ The CPI is the base for wage indexation.

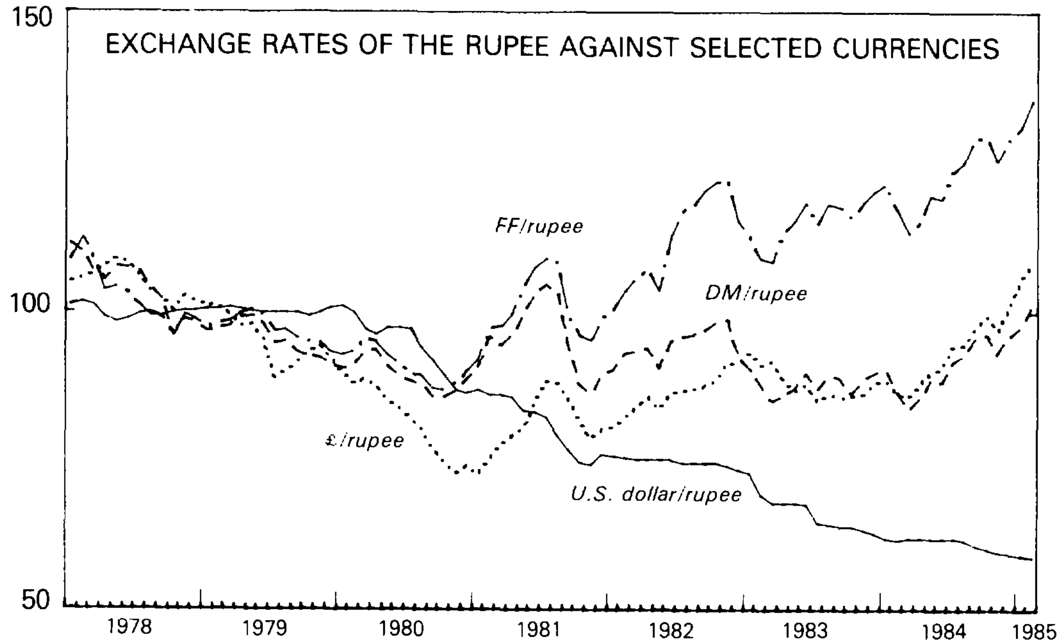
3/ The authorities consider that taking 1978-79 as a reference period is misleading, because in deciding on the magnitude of the 1977 devaluation, account had already been taken of an increase in domestic prices that was to follow the lifting of administrative controls. Since these controls were lifted only gradually, inflation during 1978-79 was lower than it would otherwise have been, temporarily improving competitiveness beyond the level originally sought.

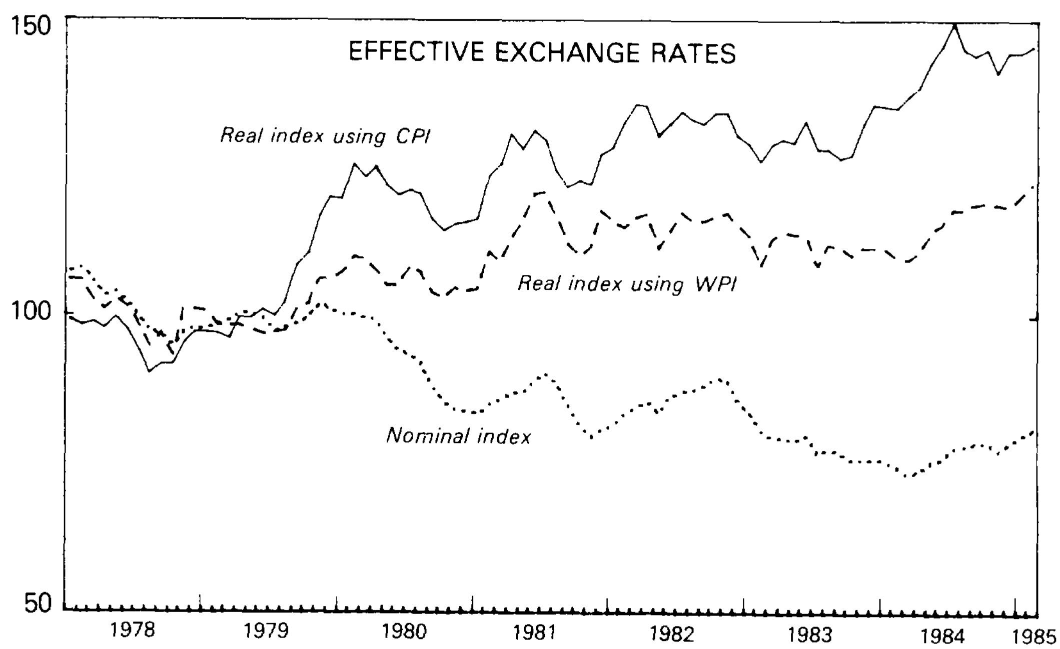
CHART 2

SRI LANKA

EXCHANGE RATE DEVELOPMENTS[1]

(1978-79 = 100)





Source: Staff calculations

[1] An increase in the index indicates appreciation

Table 4. Sri Lanka: Central Government Operations, 1983-85

	1983	1984 Budget	1984 Revised 1/	1984 Actual	1985 Budget	1985 Staff Est.
	(In millions of Sri Lanka rupees)					
Revenue	23,069	27,338	31,224	33,342	35,581	35,581
Taxes	19,862	23,348	26,973	28,037	30,215	30,215
Nontax revenue	1,707	2,290	2,601	3,655	3,966	3,966
Central bank profits	1,500	1,700	1,650	1,650	1,400	1,400
Expenditure	38,267	41,213	42,738	46,400	50,417	52,442
Current	21,600	24,740	25,432	25,295	29,115	30,075
Capital	16,667	16,473	17,306	21,105	21,302	22,367
Net lending on advance account	1,120	300	900	2,500	200	1,000
Government deficit, before grants	-16,318	-14,175	-12,414	-15,558	15,036	-17,861
Excluding Central Bank profits	(-17,818)	(-15,875)	(-14,064)	(-17,208)	(-16,436)	(-19,261)
Government deficit, after grants	-12,846	-10,025	-8,264	-11,358	-11,429	-14,254
Excluding Central Bank profits	(-14,346)	(-11,725)	(-0,914)	(-13,008)	(-12,829)	(-15,654)
Financing	16,318	14,175	12,414	15,558	15,036	17,861
Foreign financing	9,785	10,653	10,599	12,934	12,088	12,088
Grants	3,472	4,150	4,150	4,200	3,607	3,607
Foreign borrowing (net)	6,313	6,503	6,449	8,734	8,481	8,481
Of which: Commercial borrowing	(595)	(900)	(1,365)	(-267)	(242)	242
Domestic financing	6,533	3,522	1,815	2,624	2,948	5,773
Banking system	473	681	-1,826	-2,604	-1,019	673
Other	6,060	2,841	3,641	5,228	3,969	5,100
	(As percent of GDP)					
Revenue	18.9	19.5	22.3	21.8	20.5	20.5
Of which: Taxes	(15.9)	(16.7)	(19.3)	(18.0)	(17.1)	(17.1)
Expenditure	31.9	29.4	30.5	30.3	29.1	30.2
Current	18.3	17.6	18.1	16.5	16.8	17.3
Capital	13.6	11.8	12.4	13.8	12.3	12.9
Net lending on advance account	0.3	0.3	0.7	1.7	0.1	0.6
Deficit before grants	-13.3	-10.2	-8.9	-10.2	-8.7	-10.3
Excluding Central Bank profits	(-14.6)	(-11.3)	(-10.1)	(-11.3)	(-9.5)	(-11.1)
Deficit after grants	-10.5	-7.2	-5.9	-7.4	-6.6	-8.2
Excluding Central Bank profits	(-11.8)	(-8.4)	(-7.1)	(-8.5)	(-7.4)	(-9.0)
Domestic borrowing	5.3	2.5	1.3	1.7	1.7	3.3
Of which: From banking system	(0.4)	(0.5)	(-1.3)	(-1.7)	(-0.6)	(0.4)

Sources: Data provided by the Sri Lanka authorities; and staff estimates.

1/ As envisaged by the Sri Lanka authorities at the time of the previous Article IV consultation discussions held in May 1984.

tea tax receipts and measures to increase revenue from other areas. 1/ Despite an increase in defense expenditure prompted by the ethnic conflict, total expenditure as a ratio of GDP declined, mostly as a result of restraint in current expenditures. On the other hand, net lending to public corporations through Treasury advance accounts increased considerably. The reduction in the deficit, together with an increase in concessional external financing, led to a sharp decline in net domestic borrowing by the Government and allowed a substantial repayment by the Government to the domestic banking system.

Although representing a considerable improvement over 1983, the 1984 fiscal outcome was less favorable than intended at the time of the previous Article IV consultation discussions held in May 1984. Soon after approval by Parliament in late 1983 of the 1984 budget, the authorities realized that the budget, in order to bring monetary expansion and inflation under control, needed to contribute more to the control of aggregate demand than foreseen in the original budget. Consequently, an expenditure-pruning exercise was undertaken in early 1984, which was intended to result in a further narrowing of the deficit and a significantly lower need for domestic borrowing by the Government.

In the event, despite much higher revenue than anticipated, the deficit was considerably larger than forecast in May 1984. Although concessional external financing was higher, domestic financing was also significantly larger (by about 0.4 percent of GDP). This was mainly the result of overruns on capital outlays and lending through Treasury advance accounts to public enterprises that were unable to cover costs. The staff observed that the larger-than-envisaged domestic financing of the budget must have contributed to a crowding out of the private sector, as credit restraint to that sector had to carry a proportionately greater burden of controlling monetary expansion. The authorities responded that it was implausible that the private sector had been crowded out in 1984, since credit demand for investment was low in any case, partly because of the uncertain political situation and partly because some of the investment was being financed out of current buoyant incomes.

4. Monetary and price developments

One of the principal objectives of monetary policy in 1984 was to ensure an increase in external reserves, while reducing monetary expansion and inflation, both of which were running at an annual rate of over 20 percent at the end of 1983. Several avenues were used to pursue these goals. As discussed above, the Government made a large net repayment to the banking system (Chart 3 and Table 5). In addition, the

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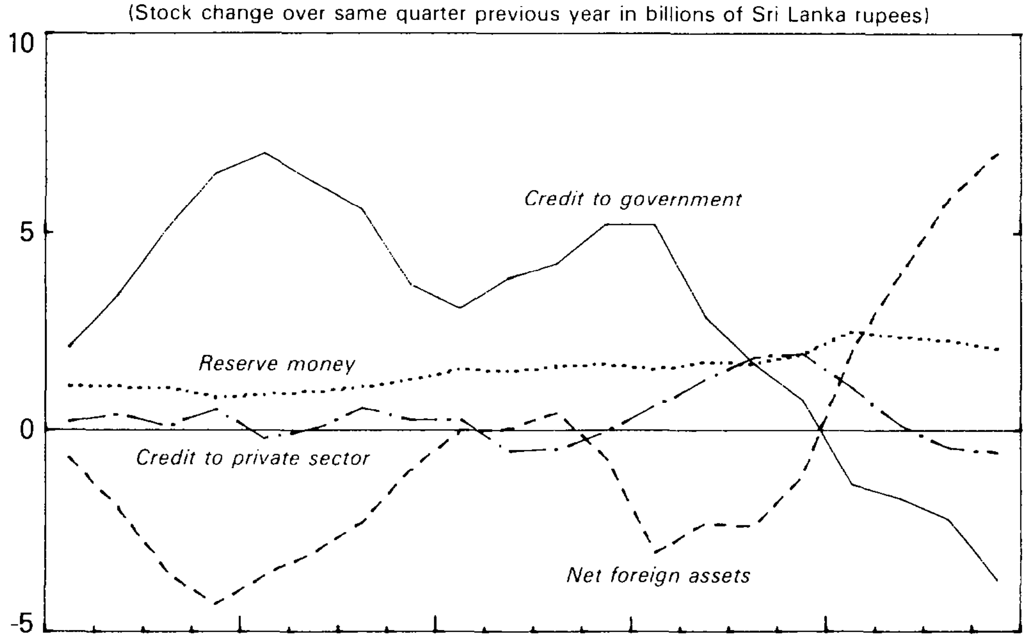
1/ It should be noted, however, that a large part of the increase in revenue was matched by higher expenditures as government imports were subject to taxation for the first time in 1984.

CHART

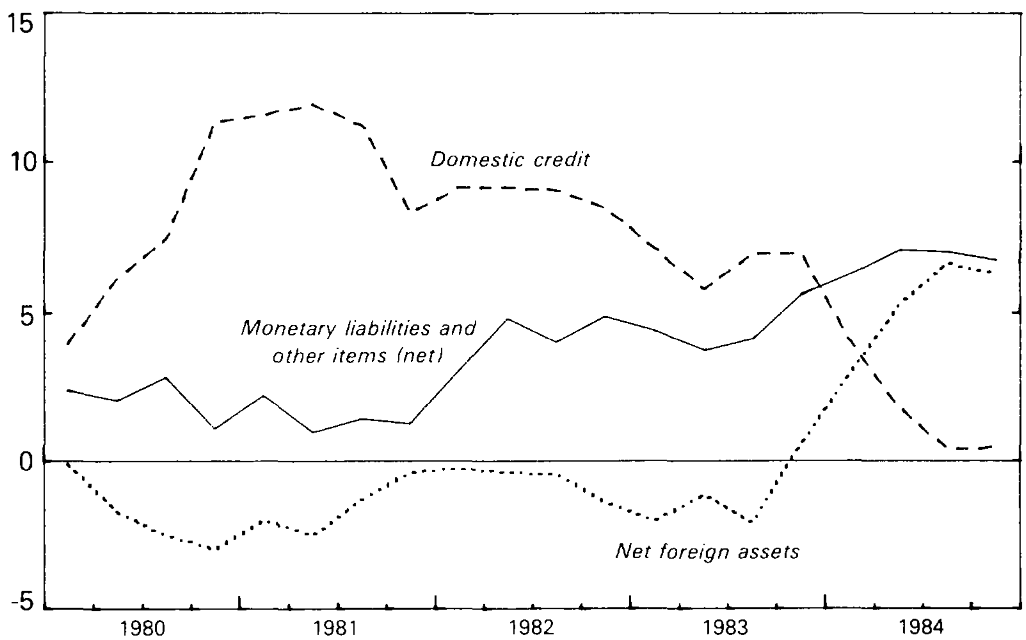
SRI LANKA

FACTORS AFFECTING RESERVE MONEY, 1980-84

(Stock change over same quarter previous year in billions of Sri Lanka rupees)



FACTORS AFFECTING MONEY SUPPLY, 1980-84



Source: Data provided by the Central Bank of Ceylon.

Table 5. Sri Lanka: Monetary Survey, 1981-85

	1981	1982	1983	1984	1985
	Dec.				Jan.
	(In millions of rupees)				
Net foreign assets	685	-718	-150	6,129	7,215
Domestic credit	33,719	42,188	49,152	49,584	49,480
Public sector	17,377	21,913	22,024	18,753	19,200
Government (net)	(12,889)	(17,236)	(17,639)	(14,605)	(15,271)
Public corporations	(4,488)	(4,677)	(4,385)	(4,148)	(3,929)
Private sector	16,342	20,275	27,128	30,831	30,280
Monetary liabilities	24,287	30,249	36,818	43,015	43,496
Money	(9,950)	(11,672)	(14,589)	16,647)	(16,338)
Quasi-money	(14,337)	(18,577)	(22,229)	(26,368)	(27,158)
	(Annual percentage changes)				
Domestic credit	32.7	25.1	16.5	0.9	-1.7
Public sector	31.4	26.1	0.5	-14.9	-16.7
Government	(41.6)	(33.7)	(2.3)	(-17.2)	(-17.8)
Public corporations	(8.9)	(4.2)	(-6.2)	(-5.4)	(-12.2)
Private sector	34.0	24.1	33.8	13.7	10.9
Monetary liabilities	23.2	24.6	21.7	16.8	14.9
Money	(6.6)	(17.3)	(25.0)	(14.1)	(10.3)
Quasi-money	(38.2)	(29.6)	(19.7)	(18.6)	(17.9)

Source: Data provided by the Sri Lanka authorities.

authorities sharply curtailed the growth of private sector credit, mainly through the imposition in March 1984 of quantitative ceilings on advances for nonessential imports and, in May, on the growth of certain other private sector credit. 1/ Central Bank rediscounting of credit to the tree-crop sector, which the Executive Board had urged be curtailed last year, was not tightened. However, since bank lending rates to prime borrowers declined somewhat while the rediscounting rate remained unchanged, the concessional margin narrowed sufficiently to discourage some exporters from applying for this rediscount facility. In a further attempt to control monetary expansion, the authorities introduced a system of auctioning Central Bank securities with a view to mopping up excess liquidity. Finally, in view of the rapid growth in the deposits of commercial banks, the Central Bank imposed incremental deposit ratio requirements for banks in November 1984.

Overall, total domestic credit grew by only 1 percent in 1984. However, as a result of the sharp increase in net foreign assets, the annual rate of growth of broad money, while declining, was still 17 percent at the end of the year. The rate of inflation, which declined gradually to an annual rate of 14 percent in October, dropped sharply in the subsequent months to reach less than 1 percent in February 1985. This sudden drop in the inflation rate since November reflects to a large extent a fall in food prices owing to the effect of good weather on domestic food supplies.

5. Growth situation

Real GDP is estimated to have risen by 5 percent in 1984, about the same rate as in 1983. Manufacturing was the fastest growing sector, led by a marked increase in tea processing and the production of garments in response to buoyant foreign demand. Other contributing factors were the uninterrupted operations of the petroleum refinery and the recovery from the July 1983 civil disturbances which had resulted in a temporary halt in production at a number of factories. Agricultural output grew by only 2 percent, because of a decline in paddy and coconut production, the former due to floods in the early part of the year, and the latter, because of the lagged impact of the 1983 drought. On the other hand, benefiting from plentiful rainfall and high prices, tea production, which declined in 1983 owing to the drought, recorded an increase of 16 percent in 1984.

1/ Credit outstanding to public corporations also declined slightly, but this reflected mainly exogenous factors, such as the better performance of the state plantation sector (due to the favorable tea prices), the Petroleum Corporation (lower world oil prices), and the Electricity Board (increased supply of hydropower).

The domestic savings-investment balance improved markedly in 1984, with a consequent decline in the reliance on foreign savings. Domestic savings increased to about 22 percent of GDP; over half of the improvement was the result of growth in public sector savings. There was also a substantial increase in private sector savings, following the restrictive credit policy for imports and the income-enhancing effect of the increase in the external terms of trade. At the same time, the rate of investment is estimated to have declined, particularly in the private sector, reflecting the languor in tourism and a wait-and-see attitude adopted by potential investors in the wake of the escalation of the ethnic conflict.

III. Report on the Discussions

1. Medium-term prospects

Despite the favorable performance of the economy in 1984, Sri Lanka must deal with important medium-term adjustment problems if reasonable growth with a viable balance of payments is to be achieved. The adjustment need facing Sri Lanka arises from the fact that, with the phasing out of the Mahaweli-related aid, 1/ foreign aid inflows are expected to slow just when debt service payments begin to grow. Furthermore, there is a need to limit external borrowing on commercial terms so as to contain the debt service burden. At the same time, official external reserves need to be maintained at a level that will provide a cushion against unforeseen developments.

Table 6 presents two balance of payments scenarios which, given different assumptions regarding concessional capital inflows, aim at maintaining gross official reserves at approximately the equivalent of three months of imports, while limiting commercial borrowing to a level that would reduce gradually the external debt service ratio from a peak of 22-23 percent in 1987 to 14-16 percent by 1990. Scenario A is based on a more conservative assumption with regard to concessional capital inflows, which is in line with the authorities' own projections. Scenario B, on the other hand, incorporates more optimistic assumptions regarding such capital inflows, based on the projections of the IBRD staff. 2/ Under Scenario A, the current account deficit needs to be reduced to about 3 percent of GDP by 1990. Under Scenario B, the higher concessional capital inflows would permit a higher current account deficit (4 percent of GDP), which, *ceteris paribus*, would allow a somewhat higher economic growth.

1/ The foreign aid component of the Mahaweli project is officially projected to decline from the equivalent of about 10 percent of total imports in 1984 to a negligible amount by the late 1980s.

2/ Other key assumptions are spelled out in Appendix Tables I and II.

Table 6. Sri Lanka: Medium-Term Outlook of the Balance of Payments, 1983-1990

	1983	1984 Prel.	1985	1986	1987	1988	1989	1990
					Projections			
					Scenario A			
Exports (annual percentage change)	8.2	44.9	-0.4	9.9	9.7	10.6	10.5	10.6
Of which: nontraditional 1/	(4.7)	(40.4)	(12.4)	(15.2)	(15.3)	(15.4)	(15.8)	(15.6)
Imports (annual percentage change)	-0.8	3.9	4.6	6.7	7.7	8.5	7.9	7.8
Current account (percent of GDP)	-12.4	-3.6	-4.9	-4.5	-4.1	-3.8	-3.4	-2.9
Capital account, net (in millions of SDRs) 2/	602 3/	512 3/	591	417	328	328	329	375
Of which: Gross disbursements on medium- and long-term foreign concessional loans (in millions of SDRs)	(266)	(315)	(365)	(300)	(310)	(310)	(300)	(290)
Gross official reserves (months of imports)	2.0	3.4	4.7	4.7	4.1	3.5	3.1	3.1
Debt service ratio (percent of exports of goods and services)	24.4	17.4	20.6	21.1	22.4	20.7	17.8	14.2
Real GDP growth (in percent)	5	5	5	5	5	5	5	5
					Scenario B			
Exports (annual percentage change)	8.2	44.9	-0.4	9.9	11.4	12.6	13.1	14.0
Of which: nontraditional 1/	(4.7)	(40.4)	(12.4)	(15.2)	(19.9)	(20.1)	(22.0)	(22.0)
Imports (annual percentage change)	-0.8	3.9	4.6	9.9	10.0	10.0	10.0	10.1
Current account (percent of GDP)	-12.4	-3.6	-4.9	-5.3	-5.2	-4.7	-4.3	-3.5
Capital account, net (in millions of SDRs) 2/	602 3/	512 3/	591	472	371	398	429	495
Of which: Gross disbursement on medium- and long-term foreign concessional loans (in millions of SDRs)	(266)	(315)	(365)	(355)	(353)	(380)	(400)	(410)
Gross official reserves (months of imports)	2.0	3.4	4.7	4.5	3.6	2.9	2.5	2.6
Debt service ratio (percent of exports of goods and services)	24.4	17.4	20.6	21.1	22.1	20.1	16.9	13.2
Real GDP growth (in percent)	5	5	5	6	6	6	6	6

Sources: Data provided by the Sri Lanka authorities; and staff estimates and projections.

1/ Excluding gems and petroleum products.
2/ Including official transfers.
3/ Including errors and omissions.

Two important conclusions can be drawn from these medium-term projections. First, domestic savings, which have stagnated in recent years, except for 1984, must be raised if adequate rates of investment are to be maintained in the face of the reduced availability of foreign savings. Second, even a relatively modest economic growth of 5 percent per annum implied under Scenario A requires nontraditional exports to grow by at least 15 percent per year, which implies continuous gains in market shares for Sri Lanka's exports. Indeed, the plantation sector cannot be relied on as the sole source of growth and employment, since real growth in that sector is not expected to exceed 2-3 percent per year--even taking into account the effects of the ongoing rehabilitation process--because of the constraints imposed by the availability of land and the long gestation period of any rehabilitation effort. Moreover, the potential for import substitution, while not insignificant, is constrained by the small size of the economy. Therefore, while the development of traditional exports and the role of efficient import substitution remain important, Sri Lanka's ability to achieve sustained rapid economic growth will largely depend on its success in developing a dynamic manufacturing industry for exports.

The authorities are in broad agreement with these conclusions. They recognize that achievement of the needed adjustment will require structural improvements in the domestic savings-investment and the external payments balances. They intend to pursue these goals by improving the general framework of incentives for the private sector, increasing governments savings, and scaling down the Government's investment program so as to free resources for the private sector.

Any balance of payments projections for Sri Lanka are highly sensitive to tea price assumptions. Although there currently appears to be an undersupply of tea in the world market, most observers forecast a decline in tea prices in real terms during the coming years, as world supply is expected to increase more rapidly in response to the higher prices. 1/ The staff's medium-term balance of payments projections presented in Table 6 assume a 2 percent decline in the average export price for tea in 1985 and an annual increase of 3 percent per annum thereafter, which implies a declining trend in real terms. While these price projections are more conservative than other forecasts the staff has encountered, even they may turn out to be on the high side. This point is dramatically illustrated by the sudden drop of about 20 percent in tea prices in March. Most observers believe that this fall in prices is due to the relatively high levels of stocks, and may therefore only be temporary. If, however, one assumes that the current prices will

1/ This is a reasonable assumption if one considers that tea prices in real terms have been on a continuously declining trend since the mid-1950s and that over the past 16 years, only once, in 1977 in response to high coffee prices, were tea prices as high in real terms as at present (Chart 4).

prevail through the rest of 1985 and then rise by 3 percent per year from that lower level, the annual loss in export earnings compared to the projections presented in Table 6 would be equivalent to approximately 2 percent of GDP. 1/ This would require a correspondingly faster--approximately 25 percent per annum--growth of nontraditional exports in order to achieve the balance of payments and growth targets.

It is against the background of these medium-term adjustment requirements and uncertainty in tea prices that current policies need to be assessed.

2. Policies in 1985

For 1985, the authorities forecast an increase in the external current account deficit to about 5 percent of GDP. Since the prices of tea, rubber, and coconuts are projected to decline, total export receipts are forecast to virtually stagnate. The growth of imports is expected to be restrained to less than 5 percent through tight credit and government expenditure policies. Receipts from tourism and workers' remittances are projected to show only a slight growth. On the other hand, capital inflows are expected to increase on account of disbursements out of the existing pipeline of aid commitments and an increase in commercial borrowings by the private sector. The overall balance of payments is projected to record a surplus of about SDR 280 million, increasing the level of gross official reserves to the equivalent of close to five months of imports. These official balance of payments projections, which formed the basis of the staff's discussions with the authorities, do not take into account the recent decline in tea prices. Staff estimates indicate that, if the current lower tea prices were to prevail through 1985, the surplus would be reduced, *ceteris paribus*, to about SDR 140 million.

The authorities forecast an increase of 5 percent in real GDP in 1985. Agricultural output is expected to accelerate as a result of a recovery of paddy and coconut production, while the growth of manufacturing output is projected to slow, largely because of an anticipated weakening of external demand and the closure of the oil refinery for scheduled regular maintenance. With regard to inflation, the authorities' objective is to keep the rate of domestic price increase at about 5 percent in 1985.

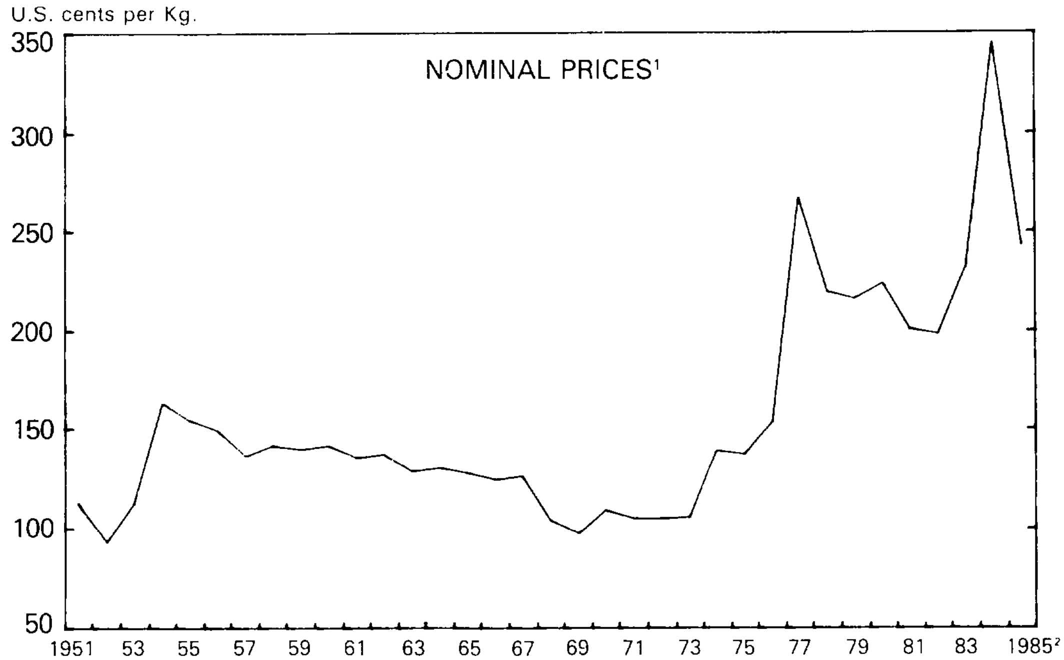
The staff supports these macroeconomic objectives for 1985, but believes that the policies are not yet fully in place to ensure their achievement.

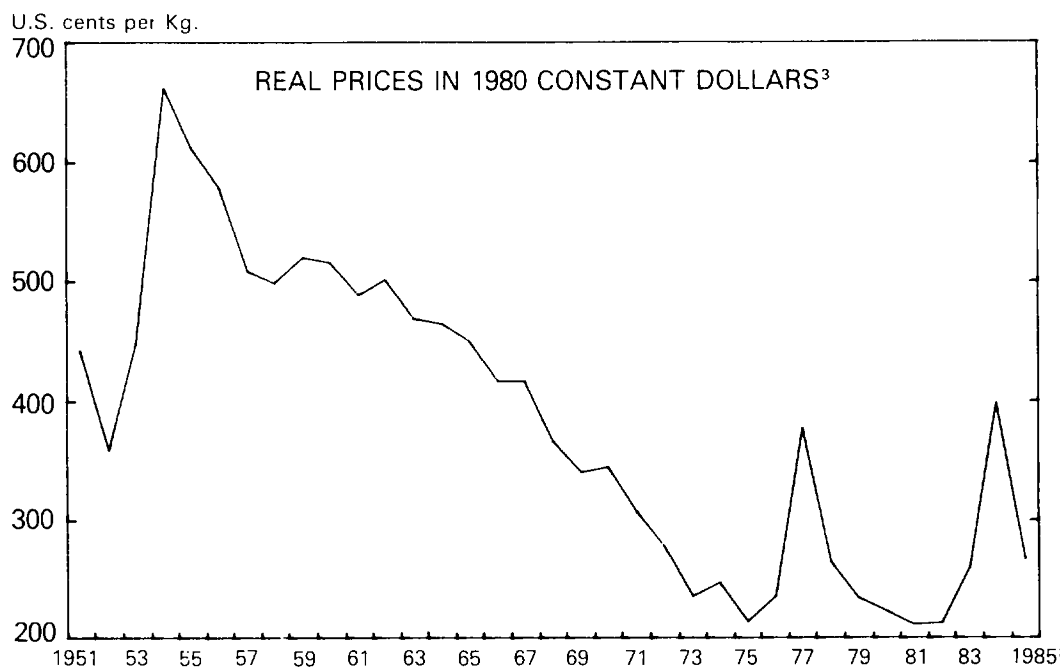
1/ Roughly, a 10 percent decline in tea prices represents a loss in export earnings equivalent to about 1 percent of GDP.

CHART 4

SRI LANKA

TEA PRICES, 1951-85





Sources: Data provided by the Sri Lanka authorities and staff estimates.

[1] Average annual prices at the London tea auctions.

[2] March 1985.

[3] Average annual London prices deflated by the Manufacturing Unit Value Index, which measures the unit value of manufactured exports from industrial market economies to developing countries. (Source: *U.N. Monthly Bulletin of Statistics*)

a. Public sector policies

The 1985 budget envisages a further reduction in the Central Government deficit by 1.5 percentage points of GDP. The reduction is to be achieved by expenditure restraint rather than revenue measures, as the authorities wish to reduce the tax burden in order to increase economic incentives. Measures intended to improve incentives include an increase in the level of exemptions as well as a widening of tax brackets for the personal income tax; a lowering of the effective rate of taxation of tree-crop exports; and tax concessions for exports. As a result, the 1985 budget foresees a decline of about 1 percentage point in the revenue/GDP ratio. At the same time, total expenditure plus net lending is also projected to decline as a ratio of GDP. This is to be achieved essentially through a 15 percent cut in capital outlays by each ministry, as well as through an anticipated decline in Treasury advances to public corporations. Despite the decision to reduce the degree of wage indexation 1/ and subsidies to state plantations, the share of current expenditures in GDP is projected to rise slightly, due mainly to selective wage increases and defense spending. As in the past, the bulk of the deficit is expected to be financed by foreign grants and aid, and another repayment by the Government to the domestic banking system is anticipated.

The staff believes that unless further measures are taken, the fiscal deficit is likely to be at least Rs 3 billion (1.7 percent of GDP) higher than budgeted, and could even be considerably larger if tea revenue were lower and defense spending were to rise faster than anticipated. This assessment is based largely on the consideration that interest payments and net lending through advance accounts are underestimated by the authorities and that if expenditure control is not strengthened, a repetition of the 1984 experience is likely, with large supplementary capital expenditures being approved at the end of the year.

The staff team recommended that a firm ceiling be put on total net lending through advance accounts and that the authorities closely monitor the capital expenditure program of each ministry to ensure that the 15 percent cut ordered by the Ministry of Finance was followed by concrete decisions to rephase low-priority projects. In the absence of such actions, a new expenditure-pruning exercise would have to be undertaken. The authorities responded that the rephasing of projects had been proceeding satisfactorily and that a new pruning exercise would be difficult politically. The staff also recommended a thorough review of the expenditure control system. While progress in this area would

1/ Starting in 1985, cost of living adjustments will be granted annually rather than semiannually.

necessarily take time, it was important that the process begin immediately. The authorities said they would welcome technical assistance from the Fund in this area.

The authorities plan to reform the food and kerosene subsidy system. At present, about 7 million people, or just under half of the population, receive food and kerosene stamps. The intention is to reduce the number of beneficiaries by about half and to raise correspondingly the level of support provided to those who remain covered by the system. 1/ The staff expressed its support for the authorities' intention of targeting the funds available for subsidies to the truly needy. This would allow the current level of expenditure to address welfare needs more efficiently, and thereby meet recently expressed concerns that the nutritional standards of the poorest had declined.

Regarding revenue policy, the staff team noted that the reduction in personal income taxation and effective export tax rates introduced with the 1985 budget came at a time of buoyant export earnings and were, therefore, procyclical. The authorities commented that their underlying philosophy was to endow Sri Lanka with a tax structure that provided sufficient incentive to the economy and that budgetary expenditures would have to be adjusted to the level of revenue so raised. While agreeing with the objective of providing improved incentives, the staff noted that given the requirement for increased expenditure on maintenance of existing capital assets--a requirement clearly identified by the IBRD and recognized by the authorities-- 2/ revenue had to be increased if the public sector deficit was to be limited. In this connection, the staff observed that the tax system lacked built-in elasticity, largely because of a multitude of legal exemptions and the fact that a significant portion of income was not brought under the tax net. The authorities were in agreement with this view and requested Fund technical assistance to review these aspects of the tax system.

The authorities have decided to establish stabilization funds for tea, coconut, and, eventually, rubber, details of which are still being formulated. The staff noted that such funds could be useful instruments

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1/ Until 1979, a food subsidy scheme had been in effect with rations made available to virtually the entire population. In 1979, a food stamp program was instituted in lieu of the subsidies, and an income test was applied to identify the beneficiaries, thereby excluding half the population from the program. The expenditures on the food stamp program have basically remained unchanged in nominal terms since 1979, while there has been little change in the number of beneficiaries. Therefore, with inflation, the real value of the food stamps has been seriously eroded over the years.

2/ Beginning in 1985, a special budgetary account has been set up for operation and maintenance expenditure. The IBRD staff has supported the establishment of such an account.

for smoothing the impact of fluctuations in commodity prices on domestic liquidity and producers' incomes, but stressed that the operation and control of these funds had to be carefully planned. Essential requirements for the successful operation of the stabilization funds were that the resources of the funds be held separate from government revenue and not be invested in securities issued by the Government; that, conversely, if the funds' resources became exhausted, the Government should not be obligated to provide financial support, and the funds themselves should refrain from seeking commercial financing in such circumstances; that the resources of the funds should be sterilized with the Central Bank or, preferably, invested abroad by the stabilization funds themselves; and that control of the funds be shared between the Government and representatives of the industry.

The poor performance of most public enterprises continues to impede economic progress. The authorities closed down two inefficient public enterprises in 1984. In addition, they recently announced their intention to turn over to the private sector the telecommunications corporation. They indicated that there was now a more favorable climate for privatization, but were of the view that progress in this area would be slow, due to lack of entrepreneurial capital and adequate accounts on which to base sales offers. Progress toward this latter end would be facilitated by a study now being undertaken under the auspices of the Parliamentary Committee on Public Enterprises (COPE) to evaluate the capital structure of all market-oriented public corporations. The staff urged a renewal of efforts to increase the financial accountability of public enterprises and also suggested that greater flexibility be granted to them in labor policy as a means of improving efficiency. The IBRD has for a long time been pressing for a rationalization of the operations of the public enterprises, and has done so recently in its 1984 country economic memorandum. 1/

b. Monetary policy

The authorities intend to maintain a tight monetary policy, by keeping the credit restrictions imposed in 1984 and by continuing to auction Central Bank securities. Their objective is to limit the growth of M1 to 8 percent in 1985. The staff supported this objective, pointing out that inflation had not yet been brought under firm control. Indeed, the sudden fall in the rate of inflation since November 1984 reflected to a large extent improved domestic food supplies rather than a commensurate easing in liquidity growth and the underlying rate of

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1/ IBRD, Sri Lanka: Recent Economic Developments, Prospects and Policies, May 4, 1984, Report No. 5038-CE.

inflation. 1/ The staff continued to urge the elimination of concessional refinancing to the tree-crop sector, which is not in need of such financing during a period of high commodity prices. This would lead to a reduction in the excess liquidity of banks which currently looms over the system and is contained only by the quantitative ceilings imposed on the banks' lending.

With a view to promoting investment, the authorities have taken steps to lower nominal interest rates. To encourage a lowering of deposit rates, the authorities deregulated the deposit rates of the National Savings Bank (NSB), which has been the pacesetter in determining deposit rates. The NSB responded by lowering deposit rates by four points since June 1984. These reductions were followed by similar reductions in commercial bank deposit rates. 2/ However, this has not led to a corresponding general reduction in lending rates. The authorities felt that one of the reasons for this stickiness was that a large portion of the banks' deposits were still composed of fixed-term deposits on which the former higher interest rates applied. The staff pointed out that the quantitative credit controls enforced on most lending activity since early 1984 tightened the credit market, leaving the banks no incentive to pass on lower costs to customers in the form of lower loan rates. The stickiness of loan rates was therefore attributable to tight monetary policy, and was an appropriate cost of containing money growth and inflation.

c. Exchange rate policy

The staff noted that the continuous appreciation of the rupee in real terms over the past several years had seriously eroded export competitiveness and therefore recommended a more active exchange rate policy in order to provide adequate incentives for exports, particularly for nontraditional exports. While the authorities recognized that some exports had lost competitiveness, they commented that exports had been doing well overall and that the balance of payments position was currently strong. They emphasized that under these circumstances, and given the volatile political situation, a depreciation of the rupee would be very difficult to carry out because of its impact on the cost of living.

1/ Staff calculations indicate that the most relevant monetary aggregate influencing the rate of inflation in Sri Lanka is M1 (see Annex II in the associated Recent Economic Developments report to be issued shortly). The rate of growth of M1 was still as high as 10 percent during the 12 months ending in January 1985, which, according to these calculations, indicates an underlying rate of inflation of about 8 percent.

2/ Despite the reductions, most key deposit rates remain positive in real terms as a result of the decline in the rate of inflation.

The staff pointed out that the good overall performance of exports had to be seen against the increase in commodity prices and the upturn in world demand which had swamped the effect of the loss of competitiveness. Furthermore, apart from garments, most other nontraditional exports of manufactures had not, in fact, done so well, which had led the Government to extend fiscal advantages and to increase preferential credit to exporters. A depreciation of the exchange rate would also help offset the i ɔort-enhancing effect of the recent reduction in customs duties implemented within the framework of a tariff reform (see following section). The staff feels that the time is now particularly opportune to adjust the exchange rate and keep it flexible, since inflation has already come down substantially and supply factors, both at home (food) and abroad (oil), continue to work in favor of lower prices. This, together with the continuation of a tight monetary policy, would make it possible to minimize the effect of a depreciation of the rupee on domestic prices.

d. Production policies

The Government made further progress in 1984 with structural reforms of the state plantations. The wages of the estate workers were raised, 1/ and steps were taken to improve their living conditions. A performance-related incentive system was introduced for estate management and staff, and improvements were made in the corporate structure and in the accounting and management information systems of the two organizations. Many of these changes form part of the Medium-Term Investment Program, developed jointly between the Government and the state plantations. Its purpose is to increase production not only through investment in replanting, factory rehabilitation and replacement of worn-out transportation equipment, but also, more significantly, by granting management more financial autonomy and demanding greater accountability in return. The MTIP has the backing of the IBRD and AsDB, whose boards have approved their contributions to a loan program in support of the project, totaling US$200 million.

In early 1985, the Government introduced a tariff reform aimed at reducing effective protection, much along the lines advocated by the IBRD and the Fund staff. The changes involved some 2,500 items; some import duty rates were raised, but most others were reduced. Certain important items, such as textiles, were not covered by the reform because of lack of political support, but the authorities plan to make further progress in this area during the period ahead. All in all, the tariff reform is seen as an important step toward a more rational incentive system that should reduce the anti-export bias of the tariff structure. The IBRD staff has welcomed the tariff changes and supports

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1/ Plantation workers, whose wages lagged behind the pay of other agricultural workers, were given a salary increase averaging 40 percent in April 1984.

the recommendation of the Presidential Tariff Commission to reduce further the level of, and narrow the disparity in, effective protection.

The Government has recently established a high-level committee to formulate an industrial strategy and to report to the Cabinet in the second half of 1985. As mentioned earlier, Sri Lanka needs to develop an export-oriented manufacturing industry and also needs to avoid the waste and distortions caused by inefficient import substitution. Bold initiatives are required, including the provision of appropriate incentives and the promotion of foreign investment that can bring in new technology, managerial know-how, and marketing expertise, as well as capital to supplement domestic savings. The review of the industrial policy by the committee provides an excellent opportunity to undertake new initiatives in this area. The IBRD staff has supported such a review and has indicated to the authorities that it stands ready to provide any assistance that they may request in this area.

3. Statistical issues

The coverage and timeliness of Sri Lanka's statistics are, by and large, satisfactory. Progress is being made in improving the presentation of monetary statistics in IFS, and the authorities expressed interest in receiving further technical assistance in this area as a follow-up to a 1983 mission from the Fund's Bureau of Statistics. On the other hand, statistics for the National Savings Bank (NSB) are still available only on an annual basis. It is important that the NSB, which has been a captive source of finance for the Government, provide timely statistics on its assets and liabilities so that its financial operations can be monitored closely.

IV. Staff Appraisal

Taking advantage of the favorable external environment, the authorities made good progress in 1984 toward improving the external and internal balance of the economy. The overall balance of payments recorded a large surplus, allowing a much needed buildup of external reserves and reduction in external commercial indebtedness. The rate of inflation was significantly reduced and the economy recorded an aggregate output growth of 5 percent, about the same as the year before. Thus, the Government has broadly realized the main macroeconomic goals it set itself a year ago. These results were achieved through a combination of government expenditure containment, increased revenue effort, and tight monetary policy.

These successes, however, leave no room for complacency. Indeed, most of the improvements in the public sector's financial position and the external accounts were the result of favorable terms of trade developments and the recovery of tea production from drought. The fundamentals of the economy remain weak, largely because of low underlying domestic savings and a narrow and virtually stagnating export base. These two problems will have to be tackled effectively if the country is to achieve sustained economic growth and a viable balance of payments in the future. The inadequate level of savings to support domestic investment is partly reflected in the deficit of the public sector, which plays a dominant role in the economy. The sluggishness of exports is due to years of neglect of the state plantation sector and an inadequate framework of incentives for developing new exports. A more rapid growth of exports is vital, not only because external debt is high and service payments are rising, but also because it is required for ensuring sustained rapid economic growth.

Since the economic reforms of 1977, Sri Lanka has achieved an average GDP growth of about 6 percent per year. This is a commendable result considering that this period included one of the deepest and most prolonged world recessions in recent history. However, for Sri Lanka to preserve the social gains achieved and to reach middle-income developing country status in, say, the next two decades, more ambitious targets need to be set. Sri Lanka has the potential to achieve such goals, but for this potential to be realized, a new momentum of policy initiatives is needed.

The medium-term investment program launched recently by the state plantations with IBRD and AsDB support should go a long way toward revitalizing this sector, and the authorities deserve praise for their determination in pushing ahead with this program. During the last consultation discussions, Executive Directors urged a reduction in the effective protection level in order to encourage the development of an efficient, internationally competitive industrial sector. The staff commends the authorities for the recent tariff reform which constitutes an important step toward reducing effective protection and eliminating the anti-export bias of the tariff structure. The establishment of a high level committee to review the country's industrial strategy provides an excellent opportunity for taking new initiatives in this area as well. The strategy will need to be export-oriented, which requires the provision of appropriate incentives for investment in export industries.

In this respect, an issue that needs immediate attention is exchange rate policy. As already emphasized by Executive Directors during last year's consultation, the current strong balance of payments position stemming from the high commodity prices should not obscure the fact that the real appreciation of the rupee over the past several years has seriously eroded the competitiveness of nontraditional exports. Furthermore, the tree-crop sector should not be regarded as immune to the effects of the appreciation of the rupee, because, if commodity prices continue to fall, the current favorable profit margins would quickly evaporate, particularly following the sharp increase in wages granted to plantation workers in 1984. The staff believes that the maintenance of a unified exchange rate at an appropriate level is essential for encouraging the development and diversification of exports. There is a need for an exchange rate adjustment and now is a particularly opportune time, because inflation is low and supply factors both at home and abroad continue to work in favor of lower prices. This would minimize the impact of a depreciation on domestic prices.

The staff supports the authorities' objectives of keeping inflation at about 5 percent in 1985 and achieving another surplus in the balance of payments during this period of cyclically high commodity prices. However, for these objectives to be realized, policies need to be strengthened. In particular, unless immediate measures are taken to improve expenditure control, the experience of 1984, when large supplementary expenditures were approved toward the end of the year, is likely to be repeated, preventing the Government from achieving the targeted reduction in the fiscal deficit. This is all the more important because if tea prices remain at their present level--which is significantly lower than the level anticipated in the 1985 budget--revenue from tea export taxes will be substantially less than expected earlier.

Efforts to improve the management and financial operations of public enterprises also need to be strengthened. The authorities intend to reform the food stamp scheme by reducing the number of beneficiaries while increasing the amount of subsidies to the truly needy. This is welcome; however, care should be taken that this reform does not lead to a significant increase in the total budgetary outlays for subsidies, lest the efforts to raise domestic savings be jeopardized.

An important weakness in Sri Lanka's tax system is that it lacks built-in elasticity. As noted by Executive Directors last year, this situation calls for comprehensive measures to improve the tax structure. The staff notes with satisfaction the authorities' intention to review the tax system with the objective of broadening the tax base and increasing the tax effort, and welcomes the use of technical assistance from the Fund in this area.

The intended establishment of commodity stabilization funds can be a useful instrument for smoothing the impact of fluctuations in prices on liquidity and incomes. However, it should be understood and accepted by all participants that the funds would be self-financing, i.e., that they would not have recourse to outside sources of funding to sustain unrealistic producer prices if the resources of the funds became exhausted. The best way to ensure this is to set the threshold price and stabilization levies at realistic levels, taking into account anticipated long-term trends in international prices.

The staff strongly supports the authorities' objective of maintaining tight monetary policy in order to bring inflation under firm control. Continued monetary restraint is important, because the recent sharp drop in the rate of domestic inflation largely reflects a fall in food prices owing to the effects of good weather, rather than a commensurate decline in the rate of monetary expansion. It is essential to reduce concessional rediscounting to the tree-crop sector at this time of high commodity prices and excess liquidity in the banking system.

Sri Lanka maintains an exchange system which is virtually free of restrictions on payments and transfers for current international transactions. As transitional arrangements under Article XIV, Section 2, Sri Lanka continues to maintain limitations on the availability of foreign exchange for personal travel abroad.

In conclusion, Sri Lanka achieved significant progress in 1984 in reducing the fiscal and external deficits and in controlling inflation. But there were notable shortcomings in policies, particularly in the areas of expenditure control and exchange rate policy. The economic impact of the deterioration of the security conditions is also an important source of concern. It is hoped that the improved external position will not lead to a relaxation of demand management policies or of efforts to deal with the more fundamental structural problems. Rather, the current favorable external situation should be looked upon as an opportunity for dealing with these problems in a less painful manner.

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

Proposed Decision

The following draft decision is proposed for adoption by the Executive Board.

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Sri Lanka, in the light of the 1985 Article IV consultation with Sri Lanka conducted under Decision No. 5392-(77/63), adopted on April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Sri Lanka continues to maintain an exchange system which, with the exception of certain limitations on the availability of foreign exchange for personal travel abroad, is free of restrictions on payments and transfers for current international transactions.

Table 1. Sri Lanka: Medium-Term Outlook of Balance of Payments, 1983-1990

Scenario A

	1983	Prel. 1984	Projections 1985	1986	1987	1988	1989	1990
				(In millions of SDRs)				
Current account	-602	-215	-310	-311	-313	-316	-315	-296
Trade balance	-801	-425	-516	-505	-513	-519	-511	-490
Exports, f.o.b.	(993)	(1,439)	(1,433)	(1,575)	(1,727)	(1,911)	(2,111)	(2,335)
Imports, c.i.f.	(-1,794)	(-1,864)	(-1,949)	(-2,080)	(-2,240)	(-2,430)	(-2,622)	(-2,825)
Services, net	-57	-60	-67	-77	-69	-64	-69	-68
Receipts	(320)	(330)	(355)	(372)	(389)	(398)	(404)	(410)
Payments	(-377)	(-390)	(-422)	(-449)	(-458)	(-462)	(-473)	(-478)
Of which: interest	(-162)	(-176)	(-192)	(-198)	(-196)	(-189)	(-184)	(-173)
Private transfers, net	256	270	273	271	269	267	265	262
Official transfers, net	160	150	141	125	100	100	100	100
Nonmonetary capital, net	442	362	450	292	228	228	229	275
Overall balance	--	297	281	106	15	12	14	79
Gross official reserves (increase -)	18	-230	-245	-47	54	52	32	-47
Use of Fund credit	-10	-9	-36	-59	-69	-64	-46	-32
Other, net	-8	-58	--	--	--	--	--	--
				(As percent of GDP)				
Current account	-12.4	-3.6	-4.9	-4.5	-4.1	-3.8	-3.4	-2.9
Trade balance	-16.5	-7.2	-8.2	-7.3	-6.7	-6.2	-5.5	-4.8
Exports, f.o.b.	(20.5)	(24.5)	(22.7)	(22.7)	(22.6)	(22.8)	(22.9)	(23.0)
Imports, c.i.f.	(-37.0)	(-31.7)	(-30.9)	(-30.0)	(-29.3)	(-28.9)	(-28.4)	(-27.8)
Services and private transfers, net	4.1	3.6	3.3	2.8	2.6	2.4	2.1	1.9
of which: interest	(-3.3)	(-3.0)	(-3.0)	(-2.9)	(-2.6)	(-2.3)	(-2.0)	(-1.7)
Official transfers, net	3.3	2.5	2.2	1.8	1.3	1.2	1.1	1.0
Nonmonetary capital, net	9.1	6.2	7.2	4.2	3.0	2.7	2.5	2.7
Overall balance	--	5.0	4.5	1.5	0.2	0.1	0.2	0.8
Gross official reserves (increase -)	0.4	-3.9	-3.9	-0.7	0.7	0.7	0.3	-0.5
Use of Fund credit	-0.2	-0.1	-0.6	-0.8	-0.9	-0.8	-0.5	-0.3
Other	-0.2	-1.0	--	--	--	--	--	--
Memorandum items:				(In millions of SDRs) 1/				
1. Targets								
Gross official reserves 2/ (millions of SDRs)	292	522	767	814	760	708	676	723
In months of imports	(2.0)	(3.4)	(4.7)	(4.7)	(4.1)	(3.5)	(3.1)	(3.1)
Debt service ratio 3/	24.4	17.4	20.6	21.1	22.4	20.7	17.8	14.2
2. Assumptions								
Gross capital disbursements on medium- and long-term foreign borrowing 4/	461	425	541	410	400	410	400	411
Of which: commercial 5/	(195)	(110)	(176)	(110)	(90)	(100)	(100)	(121)
Traditional exports	519	813	782	833	886	951	1,012	1,076
Of which: tea 6/	(330)	(605)	(566)	(596)	(632)	(670)	(710)	(752)
Nontraditional exports 7/	334	469	527	607	700	808	942	1,089
Export price of tea (SDR per kg.) 8/	2.09	2.96	2.90	2.98	3.10	3.22	3.35	3.45
Receipts from tourism 9/	96	99	105	112	118	124	130	137
Workers' remittances 10/	275	294	300	300	300	300	300	300
Debt service payments	321	307	368	411	475	477	447	391
Of which: principal 11/	(159)	(131)	(176)	(213)	(279)	(288)	(263)	(218)
Nominal GDP 12/	4,847	5,883	6,309	6,940	7,634	8,397	9,237	10,161

Sources: Data provided by the Sri Lanka authorities; and staff estimates and projections.

1/ Unless otherwise indicated.
2/ Excluding gold.
3/ Including Fund charges and repurchases and debt service arising from new disbursements; as a percentage of export of goods and services.
4/ Annual gross capital disbursements on medium- and long-term concessional borrowing are projected to average SDR 300 million during the second half of the decade, consistent with available undisbursed concessional loans as of end-1984 and annual new commitments of SDR 280-330 million.
5/ Assumes foreign borrowing consistent with a targeted debt service ratio of about 15 percent by the end of the decade.
6/ Export volumes of tea are projected to increase to 218,000 kgs. by 1990 (from 204,000 tons in 1984), consistent with World Bank projections.
7/ Nontraditional exports consist of garments and textiles, industrial products other than gems and petroleum products, minor agricultural products, and miscellaneous exports (including mining and quarrying).
8/ Tea prices are projected to increase annually by 3 percent in nominal SDR terms, beginning in 1986.
9/ Receipts from tourism are projected to increase at an average annual rate of 5 percent (in nominal SDR terms).
10/ Workers' remittances are projected to increase by 2 percent per year (in nominal SDR terms), implying a small decline in real terms.
11/ Including Fund repurchases.
12/ Nominal GDP is projected to grow at an annual rate of 10 percent in nominal terms or of 5 percent in real terms, beginning in 1986.

Table II. Sri Lanka: Medium-Term Projection of Nonmonetary Capital Inflows and External Debt, 1983-1990

Scenario A

	1983	Prel. 1984	Projections 1985	1986	1987	1988	1989	1990
	(In millions of SDRs)							
Disbursements on medium- and long-term loans, net	348	317	401	256	190	186	183	225
Concessional borrowing, gross	266	315	365	300	310	310	300	290
Commercial borrowing, gross	195	110	176	110	90	100	100	121
Amortization	-113	-108	-140	-154	-210	-224	-217	-186
Direct investment	35	35	33	36	38	42	46	50
Total net capital inflows	383 1/	352 1/	434	292	228	228	229	275
Short-term capital, net	37	-26	16	--	--	--	--	--
Total net capital inflows	442 2/	362 2/	450	292	228	228	229	275
Outstanding external debt (year-end)	2,833	3,060	3,441	3,638	3,759	3,881	4,018	4,211
Of which: Fund credit	(331)	(328)	(292)	(233)	(164)	(100)	(54)	(22)
Debt service payments	321	307	368	411	475	477	447	391
Of which:								
Interest payments	(162)	(176)	(192)	(198)	(196)	(189)	(184)	(173)
Fund repurchases	(46)	(23)	(36)	(59)	(69)	(64)	(46)	(32)
	(As percent of GDP)							
Total net capital inflows	9.1 2/	6.2 2/	7.1	4.2	3.0	2.7	2.5	2.7
Of which:								
Concessional long-term borrowing, gross	5.5	5.4	5.8	4.3	4.1	3.7	3.2	2.9
Commercial long-term borrowing, gross	4.0	1.9	2.8	1.6	1.2	1.2	1.1	1.2
Amortization	-2.3	-1.8	-2.2	-2.2	-2.8	-2.7	-2.3	-1.8
Outstanding external debt	58.4	52.0	54.5	52.4	49.2	46.2	43.5	41.4
(Excluding Fund credit)	(51.6)	(46.4)	(49.9)	(49.1)	(47.1)	(45.0)	(42.9)	(41.2)
Memorandum item:								
Nominal GDP (in millions of SDRs)	4,847	5,883	6,309	6,940	7,634	8,397	9,237	10,161

Sources: Data provided by the Sri Lanka authorities; and staff estimates and projections.

1/ Excluding net short-term capital inflows of the private sector (public corporations and private companies) and errors and omissions.

2/ Including net short-term capital inflows of the private sector (public corporations and private companies) and errors and omissions.

Sri Lanka - Fund Relations
(As of February 28, 1985)

I. Membership Status

(a) Date of membership: August 29, 1950
(b) Status: Article XIV

A. Financial Relations

II. General Department (as of February 28, 1985)

(a) Quota: SDR 223.1 million.
(b) Total Fund holdings of Sri Lanka rupees: SDR 542.14 million (243.0 percent of quota)
(c) Fund credit: SDR 325.01 million (145.67 percent of quota)

Of which:

	(SDR million)	(Percent of quota)
Buffer stock	5.2	2.3
Compensatory financing facility	31.98	14.3
Extended fund facility	237.80	106.6
Credit tranche purchases		
Ordinary resources	32.8	14.7
Enlarged access resources	17.2	7.7

(d) Reserve tranche position: SDR 5.98 million. 2.7

III. Current and Previous Arrangements and Special Facilities

(a) Current stand-by arrangement: None.

(b) Previous stand-by and extended arrangements during the past 10 years.

1. November 22, 1977-November 22, 1978: Stand-by arrangement
Amount: SDR 93.0 million; 94.9 percent of quota (full amount purchased).
2. January 1, 1979-December 31, 1981: Extended fund arrangement
Amount: SDR 260.3 million; 218.7 percent of quota, of which: SDR 80 million purchased in 1979; SDR 30 million purchased in 1980; SDR 150.3 million purchased in 1981.
3. September 4, 1983-July 31, 1984: Stand-by arrangement.
Amount: SDR 100 million; 44.8 percent of quota, of which: SDR 30 million purchased in 1983 and SDR 20 million purchased in 1984; the balance of SDR 50 million was undrawn after the arrangement was interrupted in January 1984.

Sri Lanka - Fund Relations (concluded)

(c) Special facilities during the past two years

January 26, 1983: Buffer stock financing facility (rubber)
Amount: SDR 5.8 million

IV. SDR Department

(a) Net cumulative allocations: SDR 70.9 million
(b) Holdings: SDR 0.34 million, or 0.5 percent of net cumulative allocations.

V. Administered Accounts

(a) Trust Fund Loans
(i) Disbursed: SDR 95.4 million
(ii) Outstanding: SDR 78.3 million

B. Nonfinancial Relations

VI. Exchange Rate Arrangement: Managed floating

VII. Last Article IV Consultation

Last Article IV consultation: staff discussions were held in Colombo during May 9-21, 1984; the Executive Board discussed the staff report (SM/84/150) on August 8, 1984.

VIII. Technical Assistance

Sri Lanka has in the past benefited from extensive technical assistance in the fiscal, monetary, and statistical areas. The most recent developments are the following:

(a) CBD. Since March 1983, an expert has been assigned to advise the Central Bank on rural credit matters. The Central Bank has also requested a mission to advise on the structure of the money market; this mission will be scheduled as soon as possible.

(b) BUR. A member of the Bureau of Statistics is scheduled to visit Colombo in mid-1985 to review Sri Lanka's financial statistics, in particular the proposed new format of the monetary survey.

(c) FAD. The authorities have requested a technical assistance mission to review the tax system and expenditure control. A mission is scheduled for mid-1985.

IX. Resident Representative

A resident representative has been stationed in Sri Lanka since October 1977. Mr. Mountford, the current resident representative, took up his assignment in Colombo in January 1983.

Relations with the IBRD

(In millions of U.S. dollars)

IBRD and IDA Lending 1/	Disbursed IBRD	Disbursed IDA	Disbursed Total	Undis-bursed
Agriculture	--	75.73	75.73	140.91
Industry	5.11	29.53	34.64	47.20
Irrigation	14.01	75.28	89.29	87.32
Power	85.72	31.80	117.52	36.26
Telecommunications	--	23.83	23.83	6.17
Transport	--	44.86	44.86	24.72
Social infrastructure	--	26.55	26.55	23.92
Program credit	--	15.00	15.00	--
Total	104.84	307.58	412.42	366.50
Payments	50.04	5.51	55.55	
Debt outstanding (including undisbursed)	77.7	645.67	723.37	
Commitments after December 1984	--	55.00	55.00	
IFC net commitment			18.7	
Latest economic mission	January 1984			
Aid Consultative Group	The last meeting was held on June 21, 1984 in Paris.			

Source: Data provided by the World Bank.

1/ As of end-December 1984.

Note: During fiscal year 1985, IDA committed a total of SDR \$73.5 million for projects in the areas of irrigation and tree crop rehabilitation. During the remainder of the fiscal year, IBRD is expected to present for approval two projects in the areas of transport and dairy development amounting to \$60 million.

Sri Lanka--Statistical Issues

1. Outstanding statistical issues

a. Consumer prices

The weighting pattern reflected in the official cost of living index (1952-100), as constructed by the Department of Census and Statistics and reported to the Bureau of Statistics, is extremely outdated. The items used in the compilation of this index are basically selected from a family expenditure survey among 455 manual workers' families in Colombo in 1949-50, although adjustments have been made periodically to reflect changes in consumer preferences. However, the weights of the different commodity groups have remained substantially unchanged.

The Department of Census and Statistics has revised the consumer price index (CPI) based on the information provided by the 1980/81 Labor Force and Socio-Economic Survey. The new CPI utilizes the expenditure weights derived from that Survey, valued at the May to October 1982 prices. The report containing the revised CPI was submitted to the Committee of Development Secretaries in October 1984. The revised series will be published upon approval of the report by the Committee.

b. Monetary accounts

The Bureau of Statistics has prepared a revised presentation of money and banking statistics reflecting an improved sectorization of the monetary authorities and commercial banks' accounts and more detailed reporting on the Foreign Currency Banking Units, the National Savings Bank, and other nonmonetary financial institutions. Some technical details pertaining to the revised presentation need to be discussed with the authorities before the publication of the revised data in IFS could be considered. For this purpose, a visit by a staff member of the Bureau of Statistics is envisaged as part of the mission proposals for the period May-October 1985.

c. Government finance

Data published in the 1984 Government Finance Statistics Yearbook are available through 1982. However, there is a need to compile data on financing by type of debt holder for the consolidated central government sector as well as to expand the level of detail shown in the Yearbook in respect of the operations of local governments.

d. External sector

The authorities are aware of the deficiencies in the external trade indices provided for publication in *IFS* and work is underway in improving the methodology underlying the construction of these indices.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Sri Lanka in the March 1985 issue of *IFS*. The data are based on reports sent to the Fund's Bureau of Statistics by the Central Bank of Ceylon, which during the past year have been provided on a timely basis.

Status of IFS Data

		Latest Data in March 1985 IFS
Real Sector	- National Accounts	1983
	- Prices: Consumer	Dec. 1984
	Wholesale	Oct. 1984
	- Production	n.a.
	- Employment	n.a.
	- Earnings: Minimum wage rate in agriculture	Dec. 1984
Government Finance	- Deficit/Surplus	1984 Q1
	- Financing	1984 Q1
	- Debt	Nov. 1984
Monetary Accounts	- Monetary Authorities	Nov. 1984
	- Deposit Money Banks	Oct. 1984
	- Other Financial Institutions	Oct. 1984
External Sector	- Merchandise Trade: Values	Sept. 1984
	Unit values--exports	Oct. 1984
	Unit values--imports	Aug. 1984
	- Balance of Payments	1983 Q4
	- International Reserves	Jan. 1985
	- Exchange Rates	Jan. 1985