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IMF's advice to government

Resist COL relief measures, remove VAT exemptions

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The IMF's Executive Board in a communique titled 'IMF concludes 2002 Article IV consultation with Sri Lanka,' has urged the authorities to resist broad cost-of-living relief measures and administered price adjustments that would undermine the financial viability of the budget.

The communique, called a Public Information Notice (PIN) and which was released on Wednesday further says that fiscal data available upto June suggests that the 8.5% budget deficit target as envisaged in 'Budget 2002' is achievable.They urged the authorities to extend the VAT to the retail level and remove exemptions.Following is the text of this release:

"On September 3, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Sri Lanka.*

Background

Sri Lanka's economy grew steadily during the last two decades, despite the civil conflict, which has been going on for over 19 years. During this period, financial markets were liberalized, the outward orientation of the economy was significantly increased, and a more diversified export base established. However, large fiscal imbalances (which averaged more than 9 percent of GDP during this period) led to prolonged periods of public dissaving. Slow progress in key structural areas, including civil service reform, restructuring of state-owned enterprises, financial and labour market reforms, undermined the economy's growth potential.

Faced with low reserves, large import bills, and an exchange rate level and regime (a crawling band) that was no longer credible, the authorities initiated a programme of economic stabilization. The Central Bank of Sri Lanka (CBSL) floated the exchange rate on January 23, of last year and committed to an ambitious stabilization programme, supported by a Stand- By Arrangement, which was approved by the Board on April 20 of last year. As envisaged, the current account deficit narrowed, and the CBSL succeeded in building up net international reserves with a broadly.

Stable exchange rate. At end-June of last year, the programme had met all its key objectives. However, political developments complicated economic policymaking during the second half of last year. During this time, the government was not able to take corrective policies to keep the programme on track in the face of worsening circumstances.

GDP contracted by about 1 1/2 percent in last year — the first contraction since independence in 1948. The global recession led to stagnant demand overseas for garments and textiles — which account for half of exports. Due to the drought, agricultural output declined by more than 3% and low water reservoir levels led to widespread power cuts. The attack on Colombo airport and the events of September 11 also exacerbated the slowdown. While underlying inflation was close to the program target of 8% (end-year basis) for last year, drought-affected food prices drove up the headline rate. The official Colombo Consumer Price Index (food items account for 65% of the CCPI basket) increased 10 3/4% in the 12 months to December of last year.

Although, the external reserve losses of 2000 were partly reversed, balance of payments developments last year were weaker than programmed due to the external and domestic shocks and delays in external financing. Private capital flows (including privatization receipts) fell below expectations as structural reforms were delayed and investor confidence was undermined.

After a good start, the envisioned fiscal stabilization last year did not materialize. In the second half of the year, the slowing economy and a lack of resolve weakened the budget performance considerably. Instead of declining as planned, the fiscal deficit rose last year by 1% to almost 11% of GDP. Revenue suffered from slower growth, election-related tax cuts, and a lack of progress on tax administration reform. On the expenditure side, despite tight controls on nonwage recurrent spending, the authorities failed to tackle the politically sensitive spending on Samurdhi and subsidies. Fiscal laxity intensified in the run-up to last December's elections, with the granting of large wage and pension increases. There was also an overrun in defence spending. The programme target on borrowing by public corporations was exceeded due to large losses by the Ceylon Electricity Board (CEB).

Monetary policy was constrained by the fiscal situation, requiring high real interest rates to counter exchange rate and inflationary pressures during most of 2000 and the early part of last year. However, the CBSL progressively reduced rates during the last three quarters of last year because of the weak economy. By the end of last year, the reverse repo rate was 900 basis points lower than its rate in January of last year. Despite the weak economy and the concomitant compression of credit to the private sector, broad money growth slightly exceeded the 2001 target (13 1/2%) reflecting the increased public sector borrowing requirement.

Following victory in the December elections, the UNF government committed to deal with the major economic challenges it faced and move ahead with the programme. The new government presented a strong budget in March of this year, which demonstrated their commitment to fiscal consolidation and structural reforms to lay the foundations for private sector led growth in the medium-term.

Substantial progress was made on the macroeconomic stabilization front during the first half of this year. Inflation showed a trend decline-headline inflation was in the range 8-9% for the 12 months to August, consistent with the year end target. GDP growth bottomed out in the first quarter GDP. The external position has stabilized and the rupee remained broadly stable. The CBSL continued to maintain a broadly prudent monetary stance. Fiscal consolidation has begun which is a key programme objective. The financial position of public corporations also stabilized over January-June of this year.

In addition, major initiatives have been taken to resolve the civil conflict a permanent ceasefire is in operation and peace talks are expected to begin in Thailand this month.

Economic Prospects

Modest growth of 3 1/2-4% is expected this year, reflecting in part the gradual pace of recovery in external demand. With improved rainfall, early indications are that agricultural output will rebound during the second half of this year. Although some recovery is expected in both the garment and tea sectors, which should boost manufacturing activity, significant turnaround in exports is not expected until the latter part of this year. Headline inflation through August indicates that the annual inflation target of 7-8% is achievable. The CBSL continued to maintain a prudent monetary stance and fiscal data through June suggest that the 8 1/2% deficit target is achievable. Nominal interest rates are expected to decline during the second half of this year as inflation comes down and fiscal consolidation takes hold and confidence begins to strengthen. The rupee, which is freely floating, has remained stable in recent months. The trade deficit narrowed significantly during the first four months of this year before increasing in May, and official reserves continued to rise steadily upto last month. Preliminary data suggests that recent progress on the peace front has improved the outlook for both portfolio and FDI flows. Thus, the external position is expected to strengthen, and gross official reserves are projected to rise to $ 1 3/4 billion, about 2 3/4 months of imports of goods and services.

Executive Board Assessment

Executive Directors noted that Sri Lanka is at a critical juncture – despite recent improvements, the macroeconomic situation remains fragile, and achieving sustainable high growth requires major adjustments. Directors also noted that resolution of the civil conflict and the scope for generating growth opportunities are closely intertwined.

Directors welcomed the fact that the cease-fire is already providing an economic boost to the country through lower security spending and renewed economic activity in the country's conflict-affected North and East. Sustained peace would allow budgetary resources to be reallocated to social programmes and building or rehabilitating infrastructure, especially in the war-torn parts of the country.

Directors welcomed that the government's key macroeconomic objectives under the Stand-By Arrangement had been achieved, with reserves being rebuilt and fiscal consolidation and several structural reforms initiated, especially in the public sector. Nevertheless, Directors observed that the government's adjustment programme has significant downside risks. In particular, there remain risks of drought, and the long- term electricity shortages are still a major concern. Directors were also concerned that any resumption of political uncertainties could slow down the peace momentum, and undermine the fiscal position.

Directors welcomed the authorities' intention to press ahead with fiscal consolidation, which is essential to ensuring fiscal and external sustainability over the medium term. They welcomed the introduction of the new VAT, but stressed that the government should press on with other measures to reform the tax system and administration. To contain current spending, the government should also stand firm on its disciplined approach to wage and recruitment policies and defence spending. In that connection, Directors welcomed the newly formed Defence Spending Monitoring Committee. In addition, they urged the authorities to avoid having subsidies and transfers exceed the budget provisions, and they should resist any further broad cost-of-living relief measures, including tax cuts and administered price adjustments, that would undermine the financial viability of the budget or the public corporations. If needed, the authorities should stand ready to take additional measures to ensure that the broad fiscal goals are achieved.

Directors stressed that next year's budget will need to continue the path of fiscal consolidation, with the focus on controlling current expenditure. They urged the authorities to extend the VAT to the retail level and remove exemptions. The proposed unified revenue authority would likely soon contribute to enhancing tax administration.

Directors considered that firm fiscal consolidation would enable the CBSL to maintain a prudent monetary stance, while balancing the need to provide sufficient and affordable bank credit to the private sector. While welcoming the gradual decline in policy interest rates this year, in line with the path of inflation, Directors urged the CBSL to avoid further significant easing until it is clear that fiscal consolidation has taken hold.

Directors endorsed the authorities' current exchange rate policy and their commitment to improve the functioning of the interbank foreign exchange market by implementing the Financial System Stability Assessment (FSSA) recommendations. They agreed that CBSL's intervention should continue to aim primarily at realizing the net foreign asset path of the monetary programme, with only limited smoothing of short-term exchange rate volatility.

Directors emphasized the need to strengthen the banking system, which, together with a stable macroeconomic environment, would provide a stronger basis for a gradual and sequenced form of capital account liberalization. They called for further strengthening of the CBSL's supervisory function. They welcomed the authorities' decision to tackle the problems of People's Bank and to improve the performance of the Bank of Ceylon, with the help of technical assistance from the Fund and the World Bank. The authorities were encouraged to finalize the draft law on anti-money laundering, in the light of the Financial Sector Assessment Programme (FSAP) mission's recommendations.

Looking ahead, Directors noted that a major challenge for the authorities is to press ahead with deeper structural reform measures to promote growth and reduce poverty. They endorsed the authorities' structural reform agenda, and were encouraged by the initial steps taken on the structural front. The measures to restructure the Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB), and to invite private participation in those companies under an appropriate regulatory framework, were welcomed. More ambitious privatization was recommended, which could provide resources for government debt reduction, and contribute to long-term economic growth and private sector development. Over the medium term, further reform of public expenditure and the financial sector, restructuring of public sector institutions, strengthening the tax collection agencies, and labour market reforms would serve to improve public sector effectiveness and promote private sector growth.

Directors noted that data quality and timeliness are satisfactory for surveillance. They looked forward to Sri Lanka soon subscribing to the Special Data Dissemination Standard (SDDS)."

*** Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.**

Public Information Notices (PINs) are issued (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMFs assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.