Economic Committee Papers - EC/M/66-44 - Conclusions and Recommendations on the Economy of Ceylon

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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

INTERNATIONAL DEVELOPMENT ASSOCIATION

OK MS

CONFIDENTIAL

Ceylon

ECONOMIC COMMITTEE

EC/M/66 - 44

September 6. 1966

Conclusions and Recommendations on the Economy of Ceylon

I. Introduction

1. The Economic Committee met on June 28, 1966 1/ to consider the Economic Policy Memorandum on Ceylon from the Far East Department (EC/O/66-102/1, dated June 24, 1966). The main issue before the Committee was whether Ceylon should be considered a "soft-blend" country for purposes of Bank/IDA lending.

2. After hearing reports of various Government commitments concerning future economic performance, the Committee postponed a firm decision pending more concrete evidence that the Government would implement its promises.

3. In a subsequent discussion between the Chairman and the Director of the Far East Department, Mr. Cargill indicated that further information on Ceylon's economic policies might be forthcoming in July in the Government's 1967 budget statement. This information has now been received and analyzed and is referred to in Section III below. The Economic Committee has considered these additional facts, without meeting, and its conclusions and recommendations are given in Section IV below.

II. Discussion of Policy Issues

Operational Aspects

4. At the Economic Committee meeting on June 28, Mr. Blobel reviewed the events associated with the Bank sponsored special meetings to provide assistance to Ceylon which met for the first time in July 1965 at a time when Ceylon was facing an immediate foreign exchange crisis. The Bank had been asked to help organize short-term commodity assistance initially,

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1/ Members of the Committee present: Messrs. Friedman (Chairman), Kamarck, Adler, Avramovic, de Vries, Edelman, Lipkowitz, Thompson, Weiner.
Also present: Messrs. Blobel, Hablutzel, Humphrey
Messrs. Chandavarkar, Tsusaka (IMF).

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but it was hoped that the emergency assistance to improve Ceylon's foreign exchange position would be replaced by project financing in due course, and that the period covered by the assistance would be used by the Government to improve its economic policies and prepare lists of projects suitable for possible financing.

5. There had been difficulties during the past year convincing the Government of the necessity to improve its economic policies, but the Area Department now felt that the efforts of the Bank and Fund were beginning to have some effect. The Government had taken some important steps, and was likely to take further measures, although the extent to which the Government would carry out the recommendations of the Bank economic missions remained to be seen.

6. To prepare for the change-over in the nature and composition of aid from emergency and non-project assistance to financing projects, a number of technical missions had been in the field and submitted their reports. Another Bank economic mission, scheduled to visit Ceylon in September-October, was expected to place more emphasis on the preparation of a long-range program for investments in various sectors. At the next meeting of the aid group (tentatively planned for early December), it was hoped that Ceylon would be able to submit a list of projects considered worthy of assistance.

7. A possible loan of $4 million to a development finance company (DFCC) was being considered. (It is now expected that the project will be submitted to the Loan Committee in September.) A fisheries project, which would be the subject of an appraisal mission in September/October might be suitable for consideration for an IDA credit.

Criticisms

8. In the lengthy discussion that followed, the content of the Economic Policy Memorandum was subjected to a series of criticisms, which may be summarized under the following headings:

(a) The case for Bank Group operations in Ceylon was unconvincing until intentions were matched by performance;

(b) No specific justification had been given for assistance on soft terms;

(c) Uncertainties about Government economic policies and performance adversely affected eligibility for IDA assistance as much as eligibility for Bank assistance. (It was pointed out that Ceylon had been considered ineligible for IDA assistance in the past because of its poor economic performance. Several Committee members thought that performance criteria for IDA financing should be stricter than for Bank financing.)

9. Several Committee members suggested that the case for Ceylon's eligibility for assistance on soft terms might be validly based on such considerations as (a) uncertain export prospects due to factors beyond the Government's control and (b) the long-run nature of Ceylon's capital

requirements and the need to avoid any future debt service problems. One member thought that the long-term prospects for the country's balance of payments might be such (the trend of exports coupled with a possible external transfer burden of debt service), that there could be doubts about Ceylon's creditworthiness for any significant borrowing on conventional terms; he suggested that more information should be obtained on Ceylon's balance of payments prospects, and that the export projections required further analysis.

10. There was a division of opinion in the Committee about Ceylon's recent economic performance. Some members thought that improvements had taken place and noted the latest stand-by arrangement with the IMF (made in May 1966) as indicative of the Fund's assessment of the Government's serious effort to improve the country's economic policies and of its sound balance of payments management over the short-run. They also noted the Government's decision to take steps (previously refused) to limit net food subsidies, and to deal with some other budgetary problems. Other members thought that the Government had expressed its intentions to improve Ceylon's economic performance, but that it had not yet acted to do so, and no real improvement had taken place.

11. Mr. Kamarck thought that the Government had made sufficient progress to justify initiation of Bank Group operations, with the scale to depend on the degree of further progress; that in view of this fact and the existing low debt service, an "even blend" of Bank/IDA assistance was warranted with disbursements on Bank loans being slightly higher than the amortization payments on existing Bank loans.

Longer-term Considerations

12. Mr. Blobel said that in the past uncertain political support for the Government had been a basic difficulty in the way of attempts to persuade the Government of the necessity to change its attitudes on development policies. The Area Department took the Government's decision on subsidies as an indication that the political barrier to policy changes had been broken. The Department expected that it might now be easier for the Government to deal with other economic issues, such as resource mobilization, even though it might be years before major results would be evident.

13. There was evidence that for the first time since 1956 the steady deterioration in the main indicators of performance (e.g. savings and investment rates) had been halted in the latter half of 1965. The rapid growth of current expenditures had been brought under control; there had been a significant reduction in the Government's current deficits and there were prospects of further reductions; capital expenditures had been increased in 1965, although slightly, after a period of decline; consumer goods imports were being curbed, and provision was being made to increase imports of industrial raw materials and capital goods after reductions each year since 1960. These measures were small by themselves but, coupled with the decision on subsidies, should prove to be significant in the course of the next few years.

14. Referring to the assessment of a Committee member that Ceylon was the type of country which would have difficulties in realizing a satisfactory long-term growth rate that would permit a noticeable improvement in per capita income because (a) its resource base was poor, and (b) large investments would be needed to obtain a given increase in output, Mr. Blobel said that these factors, together with a tight balance of payments position, would require a degree of good performance from Ceylon which the Bank would not ask from better endowed countries. Although earlier difficulties had been resolved for the time being, a volatile political situation could mean that there might be lapses in performance by the Government from time to time. All these general considerations meant that the Government's room for manoeuvre was small.

15. The Committee accepted the Chairman's recommendation not to reach a decision on Ceylon's performance until (after the July budget statement became available) it could more effectively evaluate the Government's intentions particularly with reference to the essential commitment not to increase net food subsidies.

Terms of Assistance

16. Mr. Blobel commented that, as the Bank was chairing the aid group to Ceylon, it would be called upon to recommend certain terms. With Ceylon borrowing about $100 million per year over the next five years, the question of terms of assistance was more important than if Bank/IDA assistance (which would probably involve relatively small amounts) alone were considered. The basic considerations in lending to Ceylon were (a) the short-term problems of liquidity and the balance of payments, and (b) exports were not expected to grow at a rapid rate. With its dependence on exports (equal to 20% of GDP), and half of foreign exchange earnings being spent on imports of basic foodstuffs, Ceylon had a very specialized economy. The main opportunity for balance of payments improvement was in import substitution, particularly agriculture but also in industry. However, the Government would in any case continue to need external assistance.

III. Implications of 1967 Budget

17. The budget contains an unequivocal statement that net food subsidies will be contained at the 1965-66 level, although the method of implementing this undertaking after 1967 is less clear. The proposed five-cent increase in the price of flour should be sufficient to maintain net food subsidies at the 1965-66 level during the coming financial year. Further drastic action will be necessary, however, to maintain the net food subsidy at its present level for the rest of the decade and beyond.

18. The Area Department, while recognizing the need for caution in the light of Ceylon's previous performance, considers that the budget is realistic and that its financial and monetary implications are likely to be non-inflationary.

19. Improvements remain to be made in the financial position of the public enterprises and policies towards the industrial corporations, as well as towards the private sector. However, certain steps have been taken to improve the financial position of the Government corporations. Also, the development proposals for 1966-67 include a number of new projects and programs which are promising, and the Government is taking a number of organizational steps to improve planning and implementation.

20. The Committee considers that, given the breakthrough on the food subsidy issue, the attempt to maintain monetary stability, and the measures to ensure a reasonable import allocation and to increase resources available for developmental purposes, the budgetary and other measures can be judged to represent a significant step forward in economic policy.

IV. Conclusions and Recommendations

21. The Economic Committee concludes that sufficient improvements have been made in Ceylon's economic performance to justify consideration of Bank Group operations, and that the proposed $4 million loan to the development finance company (DFCC) is within Ceylon's creditworthiness. The Committee recommends that Ceylon be classified as a "blend country".

22. The Committee endorses the Area Department's policy of sending frequent economic missions to Ceylon to check on progress and to assist the Government in planning investment programs for the different sectors; it notes that an economic mission is scheduled for September 1966 and will report on Ceylon's economic performance about October-November.

C. F. Owen
Secretary

Attachment

Secretary's Department

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EC/O/66-102/1

June 24, 1966

ECONOMIC COMMITTEE

Economic Policy Memorandum from
Far East Department

CEYLON

I. Introduction

1. A report "Ceylon - Recent Economic Trends" (Report FE-54) dated April 6, 1966, was circulated to the Committee under the cover of memorandum EC/O/66-46 on April 6, 1966. The summary and conclusions of this report are attached.

2. The Bank has had no lending operations in Ceylon since 1961, when it made the third of three power loans which together totaled US$38.8 million. After 1961, Government economic policy precluded further Bank lending and the economic position of Ceylon grew steadily worse. In March 1965, when a new government was voted into office, it was faced with an extremely grave economic situation. Since that time the Bank has assisted Ceylon by helping to organize two Aid meetings, one in July 1965 and the other in May 1966. As a result of these meetings, it is hoped that nearly US$100 million in non-project aid will have been received by Ceylon by the end of this year or shortly thereafter.

3. The major reason why it was agreed early last year that the Bank, rather than the IMF, should organize aid for Ceylon, was the expectation that before too long it would be possible to reduce emergency assistance in favor of project financing, and that it would then become possible for the Bank group to resume lending in Ceylon. To facilitate such a change in the purpose and composition of aid, a number of missions, organized by the Bank, visited Ceylon in late 1965 and early 1966 to identify projects suitable for external assistance in Agriculture, Education, Transport, Water Supply, Power, and Fisheries. An IFC mission also appraised the Development Finance Corporation of Ceylon. As a result of these missions, there are two projects for which the Bank group might lend in the near future. One is a loan to the Development Finance Corporation of Ceylon, which is considered by a recent appraisal mission to be suitable for a Bank loan of US$4 million. The other is a fisheries loan, the first stage of which has a foreign exchange component of US$5 million, which is now ready for appraisal.

II. Statement of Issues

4. The issue before the Committee is whether Ceylon should be considered a "soft-blend" country for purposes of Bank/IDA lending. This must be judged

both in relation to Ceylon's recent economic performance and in the light of recent economic policy decisions by the Government.

III. Discussion of Policy Issues

5. At the time of the first Aid Ceylon meeting in July 1965, Ceylon was in an economic crisis. Investment was stagnant, the demand for imported goods could not be met, there was economic dislocation due to shortages in the supply of essential spare parts and equipment, reserves were virtually non-existent and the government had little room for maneuver. In addition to agreeing that around US$50 million of emergency, non-project aid was needed, the countries represented also agreed that the Government of Ceylon should take early action on four main fronts - namely: (a) to make further progress towards monetary stability; (b) to allocate increased imports for productive purposes rather than directly to increase consumption; (c) to develop as soon as possible investment programs which would have an early favorable impact on output and on the balance of payments; and (d) to prepare a financial plan for the next few years showing the steps to be taken to increase the proportion of domestic resources to be devoted to development.

6. Pending adequate measures and firm policy decisions in these directions, we rated Ceylon in mid-1965 as only marginally eligible for IDA.

7. At the time of the last economic mission in February 1966 to Ceylon, some progress had been made. In June 1965, the Government had entered into an agreement with the Fund on a program of monetary stabilization. They had undertaken to impose ceilings on the expansion of credit for the public and private sector. Both these ceilings were successfully enforced. The government also adhered to the import licensing program agreed upon with the Bank and improved its machinery for allocating imports. Moreover, schemes for increasing domestic production, particularly in agriculture, were being developed. However, the fundamental problems of resource generation and use, and investment allocation had not been adequately tackled. In particular, no action had been taken on food subsidies, which if allowed to follow the built-in course of continuing expansion, would make it impossible to achieve the much needed increase in public savings.

8. At the recent Aid meeting in May, however, the Government announced some significant steps which it had just agreed to in a new stand-by with the Fund. These included a policy decision to contain net expenditures on food subsidies at the present levels. The Government also agreed to reduce the overall expansionary deficit in the Government budget below the lower limit agreed to with the Fund in the previous year and to give attention to the pricing policy of public enterprises and corporations. As an interim step, it agreed to impose a surcharge of 10% on the current prices of goods of those corporations which operate at a loss. In the field of welfare expenditures, the Government pledged itself to continue the policy of restraints which they had earlier imposed in the field of social services. It is studying a proposal for levying charges for higher education for the children of parents in the upper income groups. The Government also agreed to maintain a ceiling on the domestic assets of the Central Bank and to use counterpart funds in a way which will not disturb the monetary balance which is sought through other measures.

9. The policy decisions outlined above, if implemented, do add up to the beginning of a serious attack on Ceylon's fundamental problems. It has to be recognized that action on the food subsidies is politically courageous, since the Government has only a small parliamentary majority and this is an issue of extreme political sensitivity. The budget, which is due to come out at the end of July for the financial year beginning October 1966, should give further indication of the development strategy adopted by the Government.

IV. Recommendations and Decisions

10. Although Ceylon's debt service is small, it would seem imprudent for Ceylon to incur much more debt on conventional terms. Even present debt service payments will be a considerable burden in the continuing struggle for a manageable margin of liquidity and for a flow of imports adequate to support even limited economic growth. It is recommended that Ceylon be considered a "soft blend" country for the purposes of Bank/IDA lending.

I.P.M. Cargill
Director

Attachment: Summary and Conclusions of the draft economic report "Ceylon - Recent Economic Trends."

SUMMARY AND CONCLUSIONS

From economic report "Recent Economic Trends, Ceylon"

The economic situation in Ceylon improved in several respects during the past year. Financial balance was maintained, although stagnation in economic activity kept the demand for credit low. This, in combination with low imports and a 7% rise in exports, resulted in a balance in current external accounts. Some margin in foreign exchange reserves was thereby provided in contrast to the "hand-to-mouth" reserve position of late 1964 and early 1965. These improvements took place despite the fact that none of the financial support stemming from the "foreign assistance for Ceylon" meeting in July 1965 became available during 1965. Disbursement of such assistance has begun only recently.

These elements of improvement are less encouraging, however, when observed in the broader context of Ceylon's economic problems. While stabilization is essential to Ceylon's basic economic improvement, economic growth is also essential and the stabilization of 1965 was achieved without adequate growth. Import allocations, after providing for essential consumer imports, were too small to allow for any revival of investment activity, for better use of existing productive capacity or for reducing the backlog of deferred maintenance of Ceylon's productive capital. Added to the exchange constraints on economic activity were the adverse effects of droughts and floods in agriculture. The economic record of 1965 tells the results. Growth in output was much less than population growth and although public investment rose total investment in the economy was about 6% less than in 1964. Little was achieved in using the capability of the Ceylon economy to improve the volume and variety of goods for the domestic market.

Probably, in the absence of additional foreign assistance in 1965, the foreign exchange constraints of the past year were too severe to expect any basic improvement in Ceylon's economic situation. Possibilities for improvement should be better as foreign financial support begins to flow. Nevertheless, it is difficult to foresee the time when any substantial relaxation of foreign exchange constraints on the Ceylon economy will be possible, given the prospects for slow growth in Ceylon's export earnings and realistic expectations of the trend of foreign assistance.

Therefore, if Ceylon can expect to solve its politico-economic difficulties only in circumstances of a rising rate of economic growth, which seems a reasonable assumption, then the rising growth rate will somehow have to be achieved in spite of restrictive exchange shortages and severe competition for exchange between consumption uses and growth uses. This will be difficult, but it should nevertheless be possible provided appropriate policies are followed along three main lines. The first is the allocation of such exchange as is available on an efficient basis with consumption uses kept to essentials and the remainder used in a way to increase investment and output as much as possible. The second is the preparation and execution of economic development programs which will make the most of established opportunities to speed up economic growth and improve the balance of payments. The third is the acceleration of domestic saving in order both to limit import demand and to supply the domestic resources which will be necessary, along with foreign funds, to finance the programs necessary for economic growth.

As for the first policy requirement, the administration of exchange allocations has been improved in the past year. The exchange budget now reflects an assessment of exchange requirements for production as well as consumption. The assessment of additional foreign assistance needed for the remainder of 1966 at about $55 million is a better based assessment than was possible under the exchange administration of last year. Further improvement can be expected although the extent of improvement will be limited until there is a better picture of public and private import priorities. It will also be limited by administrative capacities and it would be encouraging if the administrative burden of allocations were to be steadily reduced through increasing reliance on the market and price mechanisms for allotting exchange. This might be accomplished by increased import duties and other measures which would set prices of imported goods somewhere near their scarcity value in Ceylon's difficult foreign exchange circumstances.

On the second requirement - that of devising and executing programs to accelerate the growth of output and improve the payment position, progress has been slower than in the administration of exchange. The objectives of such programs have been defined in broad terms and the ministries concerned are working out project and program details. Much of this work is impressive but so far there are few cases where definite plans are ready for execution and the rate of progress and quality of the program preparations vary considerably from department to department. Some of the work suggests very promising contributions to Ceylon's need for faster growth; others only indicate plans for continuing with patterns of public investment which have not contributed in the past to Ceylon's economic growth to an extent commensurate with cost. Nevertheless, the work underway does suggest practical possibilities for considerably improving the performance of the Ceylon economy and for doing this within the constraints of a manageable balance of payments and a realistic level of foreign assistance. Furthermore, given such a level of foreign assistance, it does not appear to be beyond Ceylon's capacity to mobilize the necessary resources.

This raises the third policy requirement; the need to accelerate the rate of domestic saving in Ceylon in order to restrain the demand for consumption imports and to provide the capital which, along with foreign financial inflows, will finance an adequate development program. For some time in the future, the trends in income and the requirements of taxation are not likely to allow for major improvements in private saving. Hence, the more significant possibilities for increasing the rate of saving will have to be found in the public sector. Clearly this can only be accomplished in the course of several years. But it will never be accomplished until a program is devised which sets the public finance targets that will have to be reached and the time and the specific steps needed to reach them.

So far the Ceylon Government has not defined its financial policy objectives nor indicated specific policy changes designed to mobilize additional domestic resources. It is clear that under present policies the trend of government saving will be downward. It is also clear that the options for moving onto a rising trend of public saving are fairly limited. In the absence of an official fiscal program for the next several years, the Bank staff has made a tentative assessment of the problem and measures that will be needed.

By 1970 it should be possible, if Ceylon's output potentials are developed, to manage with a balance of payments requiring foreign financial assistance of something like Rs. 350 million. This presupposes, however, that government resource mobilization will be adequate to restrain consumption (and hence consumption imports) and to finance investment (including transfers to private investment) in the order of Rs. 900 million. If present financial policies are continued the prospective domestic resource mobilization of the Government will be only a third of the requirements. The foreign aid assumption would cover somewhat more than another third. Of the remainder some might be raised through tax increases (e.g. higher import duties) but possibilities in this direction do not appear large. Hence fiscal improvements will have to be found mainly in economies in government spending and the only substantial possibility for this is in the outlays for subsidies.

Much could be done here through higher charges for public goods and services (government manufactures, transport fares and tariffs, etc.). However, considering all the possibilities for saving it seems clear that the main effort will have to be made in the food subsidies and especially the subsidized production and consumption of rice. If the gross cost of the rice subsidies could only be held at this year's level of Rs. 500 million (US$105 million) it should then be possible in the course of the next several years, say by 1970, to reach the public savings objectives that a manageable balance of payments is likely to require.

With financial measures of this kind, in combination with productive programs that appear practicable, it should be possible to foresee the time when Ceylon could again manage its balance of payments without an ever mounting dependence on foreign aid. So far the programs and policies essential to this prospect are not in evidence.

From economic report: "Recent Economic Trends, Ceylon" (FE-54)

Far East Department