Folder Title: Contacts with member countries: Sri Lanka - Correspondence 01

Folder ID: 1771183

ISAD(G) Reference Code: WB IBRD/IDA 03 EXC-10-4549S

Series: Contacts - Member Countries files

Sub-Fonds: Records of President Robert S. McNamara

Fonds: Records of the Office of the President

Digitized: June 28, 2013

McNamara Papers

Contacts
Sri Lanka (1969 - 1973)

SRI LANKA

CEYLON

SRI LANKA

	9/28/68	U.B. Wanninayake, Minister of Finance H.J. Samarakkody, Secretary Treasury and Perm. Secretary, Ministry of Finance W. Tennekoon, Governor, Central Bank G. Corea, Permanent Secretary, Ministry of Planning and Economic Affairs P.L.N. Liyanage, Private Secretary to the Minister of Finance
1.	3/26/69	Dr. Gamani Corea, Permanent Secretary, Ministry of Planning and Economic Affairs
2.	4/4/69	Chelliah Loganathan, General Manager and Chief Executive, Bank of Ceylon
3.	6/13/69	George Gomes, President, Development Bank of Ceylon
4.	11/4/70	Neville T.D. Kanakaratne, Ambassador to the U.S.
5.	10/15/71	Prime Minister Sirimavo Bandaranaike Ambassador T.D. Kanakaratne
6.	1/22-23/72 (Colombo)	Mr. McNamara's Impressions on visit to Ceylon (Filed in RMcN office)
7.	1/22/72 (Colombo)	Dr. N.M. Perera, Minister of Finance C.A. Coorey, Finance Secretary
8.	"	Dr. H.A. de S. Gunasekera, Secretary, Ministry of Planning and Employment Godfrey Gunatillake, Director, Plan Implementation Division, Ministry of Planning and Employment
9.	"	Maithripala Senanayake, Deputy Prime Minister and Minister of Irrigation, Power and Highways
10.	1/23/72 (Colombo)	C. Hart Schaff, UNDP Representative Representative
11.	"	Prime Minister Mrs. Sirimavo Bandaranaike H.A. de S. Gunasekera, Secretary, Ministry of Planning and Employment Godfrey Goonetilleke, Director, Plan Implementation Division, Ministry of Planning and Employment
	"	Herbert E. Tennekoon, Governor, Central Bank -- no Bank staff present
	"	<u>Lunch(ladies included)</u> Dr. N.M. Perera, Minister of Finance H.A. de S. Gunasekera, Permanent Secretary, Ministry of Planning and Employment C.A. Coorey, Finance Secretary M.D.D. Pieris, Secretary to the Prime Minister Dr. Mackie Ratwatte, Physician, Brother and Private Secretary to the Prime Minister -

	1/22-23/72 (Colombo)	<u>Others possibly met</u> C. Monerawela, Chief of Protocol, Ministry of Defense and External Affairs Tikiri B. Illangaratne, Minister of Internal and External Trade Badi-Ud-Din Mahmud, Minister of Education Punchi B.G. Kalugalla, Minister of Shipping and Tourism Felix Dias Bandaranaike, Minister of Public Administration, Local Government and Home Affairs T.B. Subasinghe, Minister of Industries and Scientific Affairs Dr. Colvin R. de Silva, Minister of Plantation Industry H. Kobbekaduwa, Minister of Agriculture and Lands George Rajapakse, Minister of Fisheries Chelliah Kumarasuir, Minister of Post and Telecommunications
12.	4/5/72	Ambassador Neville Kanakaratne Susantha de Alwis, First Secretary, Ceylon Embassy
	6/23/72	Asoka de Lanerolle, Eisenhower Fellow
13.	9/26/72	Dr. N. M. Perera, Minister of Finance N. Kanakaratne, Ambassador to the United States C. Cooray, Secretary, Ministry of Finance H. E. Tennekoon, Governor of the Central Bank N. Kappagoda, Director, External Resources Division, Ministry of Planning and Employment L. Jayawardena, Director, Perspective Planning Division, Ministry of Planning and Employment S. de Alwis, Counsellor, Embassy of Ceylon (Sri Lanka)
14.	1/2/73	Ambassador Neville Kanakaratne S. de Alwis, Counsellor, Embassy of Sri Lanka
15.	3/26/73	N. M. Perera, Minister of Finance Dr. Lal Jayawardena, Additional Secretary, Ministry of Planning and Employment S. de Alwis, Counsellor, Embassy of Sri Lanka W. M. Tilakaratna, Alternate Fund ED
16.	7/30/73	Dr. N. M. Perera, Minister of Finance Ambassador Kanakaratne
17.	5/30/74	Ambassador Kanakaratne Mr. de Alwis, Counselor of Embassy
18.	6/11/74	Mr. N. M. Perera, Minister of Finance (At dinner hosted by Dr. Sen)
19.	9/30/74	Dr. N. M. Perera, Minister of Finance Mr. G. Coorey, Finance Secretary Dr. W. M. Tilakaratna, Alternate ED, Fund Ambassador N. Kanakaratne Mr. A. Fernando, Director of External Resources, Ministry of Planning and Economic Affairs

20.	1/15/75	Dr. N. M. Perera, Minister of Finance Mr. W. M. Tilakaratna, Alternate ED, IMF Mr. L. Jayawardena, Secretary in the Ministry of Planning Mr. J. Dhanapala, First Secretary of the Embassy, Washington
21.	9/3/75	Felix Bandaranaike, Finance Minister
22.	4/28/76	Maithripala Sennayake, Minister of Irrigation Ambassador Neville Kanakaratne J. H. Lanerolle, Counselor of Embassy
	12/15/76 (New York)	Neville Kanakaratne, Ambassador to the US and to the UN (At luncheon hosted by Amb. Akhund of Pakistan)
23.	9/28/77 (Annual Meeting)	Mr. Ronnie de Mel, Minister of Finance Mr. H. E. Tennekoon, Governor, Central Bank of Ceylon Mr. Lal Jayawardena, Secretary to the Treasury and Secretary, Ministry of Finance Mr. S. Velayutham, Director of External Resources, Ministry of Planning and Economic Affairs Mr. L. E. N. Fernando, Director, Pricing and Wage Policy, General Treasury
24.	10/20/77	Mr. Esmond Wickremasinghe, Chairman, Sri Lanka Newspaper Ass'n. Neville Kanakaratne, Ambassador to the U. S.
	10/26/77	Ambassador Neville Kanakaratne (Farewell dinner for Huang Chen Chief of PRC Mission to the U.S.)
25.	11/29/77	Rajendra Coomaraswamy, Advisor to the Prime Minister on International Cooperation Ambassador Neville Kanakaratne
	3/9/78	Ambassador Neville Kanakaratne (farewell call)
26.	7/25/78	Ambassador W.S. Karunaratne (courtesy call) Mr. A.H.Shibusawa Mr. W. Rasaputram, Alt. E.D., IMF
27.	10/12-14/78 Colombo	RMcN Notes (Filed in RMcN office).
28.	10/12-14/78 Colombo	Ronnie de Mel, Minister of Finance and Planning Dr. W. M. Tilakaratna, Secretary, Ministry of Fin and Planning Mr. R. Coomaraswamy, Special Adviser to the President for International Economic Affairs Mr. S. Velayutham, Director, External Resources, Min of Fin & Plan. Mr. R. Weerakoon, Adviser, Ministry of Finance & Planning

	11/27/78	Mr. Adhikari, Mahaweli Development Project (Delivered photo album)
29.	12/4/78	Minister Ronnie de Mel, Minister of Finance and Planning
30.	2/28/80	Ronnie de Mel, Minister of Fiaance
31.	10/2/80 Annual Meeting	Hon. R. Premadasa, Prime Minister Ronnie de Mel, Minister of Finance A.C.S. Hameed, Minister of foreign Affairs Amb. W.S. Karunaratne Dr. W.M. Tilakaratna, Sec., Ministry of Finance B. Weerakoon, Secretary to the Prime Minister R. Paskaralingam, Sec., Minister of Local Government, Housing & Construction
32.	12/4/80	Gamni Desayanake, Minister of Land Development
33.	4/8/81	Denzil Peiris, Editor, SOUTH magazine
34.	5/6/81	Minister Ronnie de Mel, Minister of Finance and Planning Dr. W.M.Tilakaratna, Sec., Ministry of Finance & Planning

1

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. Robert S. McNamara

DATE: March 25, 1969

FROM: I.P.M. Cargill Cargill

SUBJECT: CEYLON - Visit of Dr. Gamani Corea, Permanent Secretary of Ceylon's Ministry of Planning and Economic Affairs

1. Dr. Gamani Corea, Permanent Secretary of Ceylon's Ministry of Planning and Economic Affairs will call on you at 9:30 on Wednesday March 26.

2. Dr. Corea was born in 1925. He took a doctorate in economics from Cambridge University and went on to do post-doctoral research at Nuffield College, Oxford in the early 1950's. He then returned to Ceylon where he took charge of the Department of National Planning and was the principal author of Ceylon's first development plan. In 1961 he became Director of Research at the Central Bank. In 1965, with the return to power of the United National Party, Dr. Corea became Permanent Secretary of the newly formed Ministry of Planning and Economic Affairs. In this capacity he has become the influential chief economic adviser to the Government and, to a large extent, has been the architect of the economic policies which have enabled Ceylon both to recover from the severe economic crisis of 1965 and to launch itself into successful long term development.

3. Dr. Corea is able and extremely articulate. He is well known in UN circles and has been much in demand to join committees and commissions dealing with the problems of aid and development. He played a very prominent part in UNCTAD. He could easily have gone to work in comfort for one agency or another but to his credit, I think, decided to stay in his country. In Ceylon his influence at present is considerable because he is a nephew of the Prime Minister and without doubt in the past four years this influence has been for the good. Sometime before March 1970 there will be general elections in Ceylon. At present it looks as though the present administration will be re-elected. If this did not happen and if Mrs. Bandaranaike were to be returned to power, it is difficult to see how Corea would last long.

4. As far as we know Dr. Corea does not wish to raise any particular issues with you. The present position on the Aid Group and on our own lending program is summarized below.

Ceylon Aid Group

5. Dr. Corea led the Ceylon delegation to the meeting of the Ceylon Aid Group in Paris on March 11. The atmosphere at the meeting was very good. Nearly all the delegates who spoke congratulated the Government of Ceylon on its economic performance. Particularly noteworthy was the fact that in 1968 Ceylon achieved its highest economic growth rate during the post-war period despite a decline in export earnings due to falling tea and rubber prices. This achievement was due mainly to the success of Ceylon's domestic food production drive together with an exchange reform in May 1968 which permitted some liberalization of the very tight import controls.

6. I attach a table showing the export performance of Ceylon in recent years and also a table showing the status of Aid Group assistance. It can be seen that although the volume of tea and coconut exports has been somewhat lower in the last three years than in 1965, the main cause of reduced earnings has been falling prices. Total disbursements by members of the Aid Group (other than the IMF) of about $150 million during this period are less than the $200 million of additional exchange earnings which Ceylon would have had available if the earnings of 1965 had been maintained in the following three years. The table on Aid Group Assistance also shows that the flow of capital from Bank Group to Ceylon has been negative since 1965.

7. Indications of countries' aid intentions suggest that commitments in 1969 will be higher than in 1968 and that total disbursements will be substantially higher due to a fairly large spillover of aid from earlier commitments. Both Germany and the United Kingdom indicated that they would provide substantially more money for Ceylon than they have provided in the past.

Forthcoming Bank and IDA Projects

8. Three appraisal missions have returned from Ceylon in the past couple of weeks. As a result we hope to make two more Bank loans in the current fiscal year, one of about $8 million as a Second Loan to the Development Finance Corporation of Ceylon (DFCC) and the other of about $20 million for a second stage of the Maskeliya Oya Hydro-Electric Project. The third project just appraised was the first stage of the development of the Mahaweli Ganga River Basin. This would be primarily an irrigation project with a small power element. Discussions are now under way within the Bank on the appropriate size of the first stage project, and we hope to present this combined credit and loan to the Executive Directors early in the next fiscal year.

9. Two other projects under preparation, which could result in loans or credits in the next fiscal year, are a land reclamation and drainage project of about $2 million and a power transmission project of about $7 million. It is possible the transmission project will be picked up by official bilateral project aid, since donor countries are anxious to move to a position where more of their aid is provided for projects rather than in the form of 'quick-disbursing' commodity aid which has formed the bulk of the foreign assistance provided to Ceylon, since the Aid Group was formed in 1965.

10. We are still working on the lending program for the next five years in Ceylon. Our preliminary work suggests that there are likely to be enough projects to absorb well over $200 million of Bank and IDA financing during the period. With the increasing desire of donor countries to provide project rather than commodity aid, it is probable that some of these projects will be financed bilaterally, leaving a total Bank/IDA program of $180-200 million.

11. Ceylon is classified as a soft-blend country. Delays in IDA replenishment have meant that lending in the current fiscal year will be predominantly from the Bank - with commitments of about $35 million from the Bank and only $4.9 million from IDA. We hope to redress the balance in future years.

Attachment

TABLE 18

ACTUAL AND PROJECTED EXPORTS 1/

		1959	1964	1965	1966	1967	1968 Est.	1969 Proj.
Tea								
Production	mil. lbs.	413	482	503	490	487	490	510
Exports	mil. lbs.	384	456	495	441	478	460	475
Unit Price	US $ per lb.	0.57	0.53	0.51	0.49	0.46	0.42	0.42
Export Value	US $ mil.	219.5	239.9	254.2	215.8	219.0	193.3	199.6
Rubber								
Production	mil. lbs.	205	246	261	289	316	315	325
Exports	mil. lbs.	206	253	267	298	291	315	315
Unit Price	US $ per lb.	0.30	0.24	0.24	0.24	0.20	0.17	0.18
Export Value	US $ mil.	62.6	60.9	63.9	70.8	58.3	54.0	58.5
Coconut Products								
Production	mil. nuts equiv.	2,306	3,000	2,681	2,486	2,421	2,600	2,800
Exports	mil. nuts equiv.	1,131	1,625	1,274	1,028	951	1,100	1,270
Average Export Value	US $ thous./mil.nuts equiv.	45.0	35.3	45.4	40.1	36.2	49.0	45.4
Export Value	US $ mil.	51.1	57.4	57.8	41.2	34.4	53.9	57.6
of which:								
Copra								
Exports	thousand cwt.	852	1,162	819	416	316		
Unit Price	US $ per cwt.	12.7	10.0	12.4	12.6	12.3		
Export Value	US $ mil.	10.7	11.6	10.1	5.3	3.9		
Coconut Oil								
Exports	thousand cwt.	1,389	2,351	1,738	1,457	1,334		
Unit Price	US $ per cwt.	17.7	13.8	17.5	15.6	13.6		
Export Value	US $ mil.	24.6	32.4	30.5	22.7	18.1		
Desiccated Coconut								
Exports	thousand cwt.	1,050	1,080	1,041	930	926		
Unit Price	US $ per cwt.	15.0	12.4	16.5	14.2	13.5		
Export Value	US $ mil.	15.8	13.4	17.2	13.2	12.5		
Other Exports	US $ mil.	22.1	28.8	26.7	24.4	25.0	25.2	33.6
Total Exports	US $ mil. 2/	355.4	387.0	402.5	352.1	336.7	326.4	349.4

1/ Except for the 1968 estimate and the 1969 projection, figures do not coincide with the export figures given in Table 15. The difference is due to the discrepancy between Customs Return data and actual foreign exchange data. Upto the end of November 1967 all export figures have been converted into dollars at the rate of $1 = Rs. 4.76, and thereafter at the current rate of $1 = Rs. 5.95.

2/ Due to rounding the sum of the individual figuresmay differ from the totals, and for the same reason the product of unit prices and export volumes may differ from export values.

Source: Ceylon Customs Return for 1959-1967 figures; Ministry of Planning and Economic Affairs for 1968-1969 figures.

TABLE 19

STATUS OF AID GROUP ASSISTANCE 1/

(in U.S. $ million)

	Australia	Canada	France	Fed. Republic of Germany	India	Italy	Japan	United Kingdom	United States	IBRD	IDA	ADB	Total
1965													
1. Commitments 2/	1.5	4.2	-	14.0	2.7	-	5.0	10.0	-	-	-	-	37.3
2. Disbursements	1.5	2.6	0.9	2.5	-	-	-	0.5	-	2.3	-	-	10.3
3. Amortization Payments	-	0.3	-	0.6	-	-	-	1.1	-	1.4	-	-	3.3
4. Interest Payments	-	0.1	-	0.1	-	-	-	0.2	-	1.5	-	-	2.0
5. Net (2-3-4)	1.5	2.2	0.9	1.8	-	-	-	-0.8	-	-0.5	-	-	5.0
1966													
1. Commitments 2/	1.1	4.2	7.7	6.3	-	-	5.0	10.0	12.0	-	-	-	46.2
2. Disbursements	1.0	3.9	0.2	9.7	1.5	-	4.6	6.8	3.5	1.3	-	-	32.4
3. Amortization Payments	-	1.1	0.2	0.9	-	-	-	1.2	-	1.4	-	-	4.7
4. Interest Payments	-	0.2	0.1	0.3	-	-	-	0.2	-	1.5	-	-	2.3
5. Net (2-3-4)	1.0	2.6	0	8.5	1.5	-	4.6	5.4	3.5	-1.7	-	-	25.4
1967													
1. Commitments 2/	1.1	4.2	n.c.	5.0	6.7	-	5.0	8.6	17.5	4.2	-	-	52.3
2. Disbursements	0.7	8.2	4.6	7.4	1.1	-	4.2	11.0	11.6	0.8	-	-	49.7
3. Amortization Payments	-	1.1	0.3	0.5	-	-	-	1.4	-	1.5	-	-	4.7
4. Interest Payments	-	0.3	0.1	0.2	-	-	-	0.2	-	1.5	-	-	2.3
5. Net (2-3-4)	0.7	6.9	4.2	6.7	1.1	-	4.2	9.4	11.6	-2.1	-	-	42.8
1968													
1. Commitments 2/	1.1	4.2	7.7	5.0	-	4.0	5.0	7.2	18.0 3/	4.9	6.9	2.0	66.0
2. Disbursements	0.9	4.6	3.1	6.1	1.0	-	7.4	10.9	21.9	-	-	-	55.9
3. Amortization Payments	-	1.1	0.3	1.4	-	-	-	1.0	-	1.4	-	-	5.2
4. Interest Payments	-	0.3	-	0.7	-	-	-	0.2	-	2.2	-	-	3.3
5. Net (2-3-4)	0.9	3.2	2.8	4.1	1.0	-	7.4	9.7	21.9	-3.6	-	-	47.4
Grand Total													
1. Commitments 2/	4.8	16.7	15.4	30.3	9.3	4.0	20.0	35.8	47.5	9.1	6.9	2.0	201.8
2. Disbursements	4.1	19.2	8.8	25.7	3.7	-	16.2	29.2	37.0	4.4	-	-	148.3
3. Amortization Payments	-	3.5	0.8	3.3	-	-	-	4.6	-	5.7	-	-	17.9
4. Interest Payments	-	0.9	0.2	1.3	-	-	-	0.8	-	6.7	-	-	9.7
5. Net (2-3-4)	4.1	14.8	7.9	21.1	3.7	-	16.2	23.7	37.0	-7.9	-	-	120.6

1/ Includes commodity aid, project aid and technical assistance. The figures for disbursements, amortization and interest payments represent total payments during each calendar year and therefore include transactions against all existing commitments, including agreements signed prior to 1965.

2/ Refers to agreements signed.

3/ Includes Export-Import Bank loan for hotel construction.

Source: Ministry of Planning and Economic Affairs and Central Bank of Ceylon.

2

Form No. 57

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. Robert S. McNamara

DATE: April 3, 1969

FROM: I.P.M. Cargill

SUBJECT: CEYLON - Mr. Chelliah Loganathan

Library

1. Mr. Chelliah Loganathan is General Manager and chief executive of the Bank of Ceylon which is Ceylon's largest commercial bank (50% of total deposits). He is in the U.S. mainly for discussions in New York with his correspondent banks. His visit to Washington is primarily personal since one of his daughters is married to a Ceylonese - Athishdam Tharmaratnam - working in the Finance Division of our Treasurer's Department.

2. Mr. Loganathan has been General Manager of the Bank of Ceylon since the early 1950's. Under his leadership the Bank of Ceylon has expanded rapidly helped by legislation in 1961 which prevented Ceylonese from opening new accounts in non-Ceylonese banks. Despite the fact that the Bank of Ceylon was nationalized in the late 1950's, he has always been prepared to fight against any government interference in the operations of the Bank of Ceylon which has continued to maintain high banking standards. At times he has been strongly critical in public of government policies but his capability as a banker has always insured that he kept his position as General Manager.

3. In addition to running the Bank of Ceylon, Mr. Loganathan has been involved in many other activities. For many years he has been advocating a scheme for tapping small savings in underdeveloped countries. Essentially, this scheme involves setting up government-sponsored unit trusts whereby the small savings could be channelled into the shares of private sector industrial enterprises thereby providing both an increased volume of savings and a less hostile attitude from the population at large towards capitalistic enterprise. More recently he has linked this scheme with the provision of aid from international institutions. I attach an exchange of letters he had with you recently on this general subject together with a copy of his latest summary of his proposals which also he sent to you recently.

4. It is possible that Mr. Loganathan may retire from the Bank Ceylon and become General Manager of the Development Finance Corporation of Ceylon (DFCC) when the present General Manager retires later this year. We would be in favor of this, but I suggest that you do not mention the matter to him since it has only been raised with us unofficially and the Board of Directors of DFCC have not yet made a decision.

Attachments

President has seen

3

From Mr. Cr[illegible]
for 6/13 meeting of the Board

June 11, 1969

Mr. George B. S. Gomes was born in 1917. He has been a director of DFCC since 1959 and Chairman since 1968. After his education at the University of Ceylon, Mr. Gomes first entered business in a family-owned insurance company, and subsequently joined the Associated Newspapers of Ceylon Limited, of which he has been the Managing Director since 1950. This group dominates the publishing field in Ceylon, publishing 13 newspapers and magazines, including the Ceylon Daily News, which has the largest circulation in Ceylon of all newspapers. Mr. Gomes is a director of at least ten other companies in Ceylon, including four large tea companies.

The Development Finance Company of Ceylon was established by legislation in 1955, following the recommendation of a Bank survey mission in 1951, with total resources of about $4 million equivalent. Its shareholders consisted of private domestic and foreign investors; the largest shareholder, the Bank of Ceylon, was nationalized in 1961. DFCC conducted its operations on a small scale until recently, because of the slow pace of private industrial development in Ceylon and the unfavorable political and business climate until the present Government came into power. The Bank made a loan to DFCC of $4 million in November 1965. The major portion of the Bank loan has been committed, and a second loan of about $6.5 million is under negotiation. The Chief Executive of DFCC is its General Manager, a position held by Mr. L. A. Weerasinghe (brother of the Ceylon Ambassador in Washington) since 1963. Mr. Weerasinghe will be retiring at the end of this month and will be succeeded by Mr. C. Loganathan now General Manager of the Bank of Ceylon and a leading banker with international reputation. DFCC is expected to become a more active and important institution under the guidance of Mr. Gomes and Mr. Loganathan.

* * * *

President has seen

4

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Records

DATE: November 6, 1970

FROM: J.-D. Roulet

SUBJECT: CEYLON - Courtesy Call on Mr. McNamara by Ambassador Kanakaratne

1. Mr. N. Kanakaratne, Ceylon's new Ambassador to the U.S., paid a courtesy call on Mr. McNamara on November 4, 1970. Mr. Cargill and I were present.

2. After the customary exchange of pleasantries, Mr. Kanakaratne said that he mainly wanted to convey his Government's desire to maintain close working relations with the Bank Group. He pointed out that the Minister of Finance, N. M. Perera, in his recent budget speech, after stressing Ceylon's economic difficulties, stated that Ceylon would continue to need foreign aid including assistance from the Bank Group. The Ambassador wished to emphasize that if foreign assistance and the Bank Group had been criticized during the campaign, and at times after the elections, this was not the Government's position (he mentioned later on that the Prime Minister had instructed him to stress this point) and he hoped that the Bank Group was not offended by the criticism. He believed one had to recognize that the Government's task was complicated by the fact that it was under strong pressure from certain segments of Ceylon's population.

3. Mr. McNamara said he was pleased to hear about the Government's desire to maintain close relationships with the Bank Group and he assured the Ambassador that the Bank Group was not offended by the criticism. The Bank was not ideologically minded and it dealt with various kinds of countries. Close association was, of course, only possible if the Government recognizes the need for assistance and in this respect he was glad to hear the Ambassador's remarks. He mentioned that in Copenhagen he had listened with great interest to Minister Perera's speech.

4. Mr. McNamara pointed out that while the Bank was prepared to continue providing assistance, the fact that the last few months had been spent by the Government in appraising the situation (which included review of major Bank-financed projects) made it unlikely that further loans could be made during the current fiscal year. Mr. Cargill noted that since the new Government had taken office, contacts between the Bank and Ceylon had been infrequent. An economic mission was now about to arrive in Ceylon and he himself planned to visit Colombo early in December. He hoped that this would facilitate resumption of a continuous dialogue. The Ambassador agreed that things had slowed down while the Government was appraising the situation and preparing its first budget, but he felt confident that they would now start moving again.

5. With reference to the forthcoming economic mission, Mr. Cargill said that the Bank was aware that the Government was under strong pressure to deal with a number of social problems, including in particular the problem of unemployment. The mission would attempt to ascertain the dimension of these problems and their implications for future policy, inter alia by examining growth trends in population, labor force and school-age population. The Ambassador pointed out that in the new budget a substantial amount had been allocated for an employment program.

President has seen

6. It was pointed out that the Highway and Mahaweli Projects were among those requiring immediate attention. Regarding Mahaweli, proposals for revision were on their way to the Bank. Mr. Cargill reiterated the point made previously on several occasions about the need for expatriate consultancy expertise. The Ambassador stated that in a sense the Mahaweli project had become the victim of an old dispute in Ceylon between engineers and planners/administrators. Because the issue arose shortly before the elections, it became political. In his opinion, however, this did not mean that that the Government shared the views of the engineers and he believed that this problem could be solved.

7. The Ambassador concluded by expressing the hope that Mr. McNamara could find an opportunity to visit Ceylon on the occasion of one of his next trips to Asia.

cc: Mr. McNamara
Mr. Knapp
Mr. Cargill

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. Leif E. Christoffersen

DATE: November 3, 1970

FROM: Sander L. Feldman *slf*

SUBJECT: CEYLON - Courtesy Call by Ambassador Neville T.D. Kanakaratne, Ceylon's Ambassador to the U.S., at 5:00 p.m. on November 4, 1970

1. Prior to his present appointment on September 1, 1970, Kanakaratne was Minister, Economic Affairs, Ceylon's High Commission in the U.K. Attached is his curriculum vitae.

2. The visit is billed as a courtesy call and the Ambassador has not indicated that he wishes to raise any particular questions regarding Bank-Ceylon relations. It would be surprising, however, if he did not reiterate what he has already said at meetings with Mr. Cargill, i.e., that Government wishes the Bank to continue its operations in Ceylon and to continue as Chairman of the Aid Group. In Copenhagen, Mr. Cargill told the Minister of Finance, Mr. N.M. Perera, that it was important for Ceylon to create a climate where Aid Group members will be willing to continue providing assistance and to let them know that the Government wished the Aid Group to continue.

3. On operational matters, the main problems relate to proposals for revising the Mahaweli Ganga Project (Loan 653-CE and Credit 174-CE - not yet effective) and the Highway Project (Loan 569-CE and Credit 133-CE). The Government has emphasized their willingness to receive an economic mission later this month. Further lending operations at present are modest and tentative with no new projects envisaged this year. An education project and a power transmission project are possibilities for FY'72.

President has seen

MR. NEVILLE T. D. KANAKARATNE

CURRICULUM-VITAE

Born:	July 19, 1923
Educational:	Royal College, Colombo University of Ceylon - B.A. (Hons) History University of Cambridge - M.A., LL.B. Barrister-at-Law, (Middle Temple, London) Advocate of the Supreme Court of Ceylon.
1956	Ceylon Delegate to the Harvard International Seminar on Contemporary International Affairs.

Professional:

Sept.1951 - Sept 1957 - Crown Counsel in the Department of the Attorney-General of Ceylon.

Oct 1957 to Mar 1961 :	First Secretary and Legal Adviser, Permanent Mission of Ceylon to the United Nations.
	Legal Adviser to, and Member of, the Ceylon Delegations to the 12th, 13th, 14th, and 15th Sessions of the General Assembly of the United Nations (1957, 1958, 1959, 1960).
1958 and 1959 :	Representative of Ceylon to the 4th and 5th Sessions of the Committee on the Right of Everyone to be free from Arbitrary Arrest, Detention and Exile.
Mar 1958 :	Delegate of Ceylon to the U.N. Conference on The Law of the Sea, Geneva.
June 1958 :	Delegate of Ceylon to the Conference on International Commercial Arbitration and the Enforcement of Foreign Arbitral Awards, New York.
Aug 1958 :	Alternate Delegate of Ceylon to the IIIrd Emergency Special Session of the General Assembly of the United Nations.
Mar 1959 :	Representative of Ceylon at the 14th Session of the Human Rights Commission.
Mar 1959 :	Delegate of Ceylon to the U.N. Conference on the Elimination or Reduction of Future Statelessness, Geneva.
Jul 1959 :	Representative of Ceylon at the 10th Session of the General Assembly Committee on Information from Non-Self-Governing Territories.

---- more ----

Mar 1960	:	Delegate of Ceylon to the Second U.N. Conference on the Law of the Sea, Geneva.
Apr 1960	:	Chairman, Special Committee on Educational Conditions in Non-Self-Governing Territories.
Jul 1960	:	Representative of Ceylon at the 11th Session of the General Assembly Committee on Information from Non-Self-Governing Territories.
March 1961	:	Joined United Nations Secretariat on personal invitation of the late Secretary-General, Dag Hammarskjold. ✓
Mar 1961 to Jan 1962	:	Legal Adviser to the Secretary-General's Special Representative in the Congo. ✓
Feb 1962 to Mar 1964	:	Legal and Political Adviser to the Commander, United Nations Emergency Force in Gaza. ✓
Aug - Oct 1963	:	Member of U. Thant's 8-man Fact-finding Mission to Malaysia.
Mar 1964 to May 1965	:	Legal Adviser to the Commander, United Nations Peace-keeping Force in Cyprus and to the Secretary-General's Special Representative in Cyprus. ✓
Sept 1965	:	Left United Nations Secretariat.
Sept 1965 to June 1966	:	Senior Fellow, Centre for International Studies, New York University. ✓
Sept 1966	:	Member of Ceylon Delegation to the 21st Session of the General Assembly of the United Nations. Vice-Chairman, Fourth (Trusteeship & Colonies) Committee of the General Assembly.
July 1967	:	Minister (Economic Affairs), Ceylon High Commission, London.
June 1969	:	Elected to Central Council of the Royal Commonwealth Society, London.

- - - - - - - -

5

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

CONFIDENTIAL

TO: Memorandum for Record

DATE: July 13, 1972

FROM: I.P.M. Cargill

SUBJECT: Ceylon - Mr. McNamara's meeting with the Prime Minister

Mr. McNamara and I met with the Prime Minister of Ceylon, Mrs. Bandaranaike, on October 15, 1971 at the Ceylonese Embassy in Washington. The Ambassador and members of the Embassy staff were present.

The discussion turned to the aid program for Ceylon. Mrs. Bandaranaike said that she was well aware of the need to take actions to ensure a resumption of economic growth in Ceylon. The Government had been facing great difficulties in proposing appropriate actions in view of the insurgency which had occurred earlier in the year and which was due entirely to the dissatisfactions felt by young people over their own economic prospects. However she and her fellow Ministers had spent a great deal of time trying to inform the people of Ceylon about the serious problems the country faced and the measures which would be needed to overcome these problems. Certain measures would be introduced at the time of the Budget and she herself would announce the measures both in Parliament and over the radio.

Mr. McNamara said that he appreciated the great difficulties Ceylon was facing and welcomed the statement of the Prime Minister. He said in response to a question by the Prime Minister that he did hope to pay a visit to her country in the near future.

IPMCargill:bg

President has seen

Facing a crisis of major proportions
declining exports
and a/c deficit
rising unemployment

CEYLON

BRIEF FOR MR. MCNAMARA'S MEETING

WITH PRIME MINISTER BANDARANAIKE

Measures: "make sacri. now" —
1. reduce imports
2. shift spend. from
cons. to invest. +
prod.
a) limit growth of cons. spend.
b) inc. tax + price sugar
rice - tax struc. + reduce
curr. spend.

The meeting has been set for Friday, October 15, 1971 at 9.00 a.m. at the Ambassador's residence (2503 Thirtieth Street, N.W.). Ambassador Kanakaratne will attend and, for the Bank, Mr. Cargill will be present.

At 3.00 p.m. the same day, Mrs. Bandaranaike is expected to meet with Mr. Schweitzer. Although her visit to Washington is described as unofficial (she came to the United States to address the U.N. General Assembly), she is expected to meet Secretary of State Rogers and President Nixon on October 19.

3. expand agri. prod.

I. BIOGRAPHICAL DATA

Mrs. Sirimavo Bandaranaike is Prime Minister as well as Minister of Defence and External Affairs and Minister of Planning and Employment. Born in 1916, of a prominent Singhalese land-owning family, she married Mr. Solomon W.R.D. Bandaranaike in 1940, who became a member of Ceylon's first Cabinet after independence in 1947. In 1951, her husband broke from the United National Party to form the Sri Lanka Freedom Party (SLFP), appealing broadly to the Singhalese Buddhist lower and middle classes, and became Prime Minister in 1956 following the SLFP victory in the general elections. The following years were marked by the Singhalese-Tamil riots of 1958 and a state of emergency. In 1959, Mr. Bandaranaike was assassinated and in the subsequent wave of emotion, his wife was asked by the party leaders to assume the leadership of the SLFP. Following her victory in the 1960 election, as leader of a leftist coalition, she became the first woman to assume the duties of Prime Minister in modern times. At this point, however, her lack of experience and the fact that she had been used as a vote-getter made it impossible for her to control effectively the disparate elements within her Cabinet even though she may have been the most pragmatically minded person in the Government and was actually described by some Ministers as "the only man in the Cabinet". Her Government fell in 1965 as a result of defections over an attempt to nationalize the press. In the general election of that year, the United National Party was returned to office and for the following five years she led the opposition. In May 1970, she returned to power with a sweeping majority in Parliament. Her first year in office however, was one of the most troubled in Ceylon's history. Although she seems aware of the need for drastic action and may be the only person with sufficient influence to take action, she seems reluctant to assume full control and reportedly wishes to proceed only with Cabinet unanimity on major issues.

Mr. Neville Kanakaratne, Ceylon's Ambassador to the U.S.A., was educated at the University of Cambridge and is a Barrister-at-Law (Middle Temple, London). Born in 1923, he joined the Public Service in 1951 as Crown Counsel in the Department of the Attorney-General of Ceylon. In 1957-1961, he was the First Secretary and Legal Adviser to the Permanent Mission of Ceylon to the United Nations. In 1961, he joined the United Nations Secretariat on personal invitation of the late Secretary-General, Dag Hammarskjold and served as Legal Adviser to the Secretary-General's Special Representatives in Congo, Gaza and Cyprus. In 1967, he became Minister (Economic Affairs) of Ceylon's High Commission in London where he remained until his appointment as Ambassador to the United States in August, 1970.

II. CURRENT POLITICAL SITUATION

During the last few months, the Government has succeeded in bringing the April insurgency under control and in reasserting its authority in most areas. A curfew is still in force in the Western Province (including Colombo). The extent of continued resistance is not clear, however, since tight censorship has been imposed. For the same reason, it is most difficult to get the true facts. In an address to Parliament last July, Mrs. Bandaranaike gave certain figures which throw some light on the extent of the violence: total deaths were given as not more than 1,200, (at about the same time, foreign correspondents mentioned figures up to 10,000) of which 60 were among Government forces. Up to 14,000 people were arrested, of which about 10,000 are still being held, mainly in university campuses. At the time, total damage to the economy, including loss of production, was tentatively assessed at Rs.100 million ($14-15 million).

A variety of reasons for the insurgency has been put forward, including the high level of unemployment particularly among educated youth, the lack of growth of income and opportunities, and perhaps above all an overwhelming sense of frustration among the younger sections of the population with a system which, despite recourse to democratic rule, saw hardly any change in the group of political leaders since the 1930's. (It is significant to note that when calling citizens to join voluntary armed forces at the height of the insurgency, the Government specifically excluded all those under 35 years of age).

III. THE ECONOMY

The Country Program Paper of March 19, 1971 and Mr. Cleveland's note of September 24, 1971, attached as Annexes 1 and 2 respectively, summarize recent economic events. In brief, these have fully confirmed the fears expressed by our Missions last December and in February of this year. Actually, the April insurgency has made matters considerably worse and it is now just as difficult as before - if not more - to see how Ceylon can surmount its tremendous difficulties.

By way of illustration, Government revised estimates for the 1971 Budget show a current account deficit of Rupees 353 million ($60 million) as against the originally estimated surplus of Rs.26 million ($4 million). Imports were only maintained at the 1970 level ($400 million) through the use of additional short-term credits. Even this level of imports was only maintained with a $25 million cash loan from mainland China. In all likelihood, next year's import capacity will be heavily reduced.

For all practical purposes, Ceylon has by now fully used I.M.F. resources and may only hope to finance repurchases through new drawings.

An I.M.F. Mission has been scheduled for November 11-25. It will precede by a few days the Bank's Economic Mission, scheduled to arrive in Colombo about November 17 for about a month.

IV. POINTS FOR DISCUSSION WITH MRS. BANDARANAIKE

1. Economic Policy

Mrs. Bandaranaike's visit is primarily of a courtesy nature and she is not expected to raise specific issues. She is likely, however, to inquire in general terms how we view Ceylon's economic prospects and what we might advise the Government to do.

At the last Aid Group meeting in April, Minister Perera announced that a policy package containing proposals for mobilizing a substantial amount of additional resources in support of an employment oriented development program as well as other reform measures (e.g. land reform) would soon be submitted to Cabinet. This has since then been done, but no decision has yet been taken. During the Annual Meeting, he said that he expected this package to be announced together with the next budget, scheduled to be presented to Parliament on November 8, and a new development plan for the years 1972/1976.

Basically, what is needed is:

(a) a redirection of expenditures from consumption to production oriented activities involving the creation of additional employment opportunities;

(b) a financial policy package of sufficient size to enable the Government not merely to slow down, but visibly to reverse, the trend towards economic decline and rising unemployment; and

(c) a comprehensive approach, rather than a succession of small steps, to Ceylon's problems of economic growth and unemployment, as Professor Seers has convincingly demonstrated in a report he recently prepared for the Government under ILO sponsorship.

Generally speaking, these points are made in Ceylon's proposed new development plan. As the plan, however, does not clearly spell out the implications, a note attached as Annex 3 has been prepared to serve as a basis for discussion which, if appropriate, could be left with her.

2. The AID Group

There is still much sympathy for Ceylon in the Aid Group, but patience is not limitless and this feeling ought to be put across to the Prime Minister. Should the Government show evidence of action conducive to development, one can be fairly confident that the Aid Group, which is presently expected to meet again next March/April, would be willing to provide considerable support.

3. Ceylon's Debt Problem

The Prime Minister may touch upon Ceylon's debt burden. Annex 4, based on fragmentary information available here, gives an indication of the magnitude of the problem.

The major difficulty is that Ceylon's debt servicing problem is not due to large payments owed on account of official aid, but results from borrowings from commercial banks and heavy recourse to private short-term credits. This would make any debt relief exercise difficult. However, unless a solution is found, the impact of future aid will be seriously weakened and the problem therefore cannot be ignored by the Aid Group. We expect to raise it at the next meeting and, to that end, data is presently being collected in Ceylon. What our role, if any, should be beyond bringing the problem to the attention of the Aid Group, will have to be considered at that time.

4. Bank/IDA Operations

Tables showing the status of our current loans and credits are attached as Annex 5. No major issue is presently outstanding and Mrs. Bandaranaike is unlikely to raise operational questions.

South Asia Department

October 13, 1971

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. I.P.M. Cargill

DATE: September 24, 1971

FROM: Alfred S. Cleveland

SUBJECT: CEYLON - Recent Economic Developments

The following notes on Ceylon's economy have been prepared largely from data requested in late July and received only a few days ago. In general, the data indicates that the economy has continued to deteriorate in 1971 and that 1972 will be even more difficult than was visualized by the Bank at the time of the last economic mission.

THE BALANCE OF PAYMENTS

Exports

The latest estimate of Ceylon's merchandise exports in 1971 is $323 million or about $13 million less than both the original 1971 forecast and actual export earnings in 1970. The principal reasons are the decline of export earnings from tea, despite higher prices; and lower production, exports and import prices for rubber. The materials supplied to us do not so indicate but undoubtedly the insurrection was an important cause of the decline.

Imports

The original preliminary import program for 1971 totaled about $460 million which in the Bank's view was some $80 million in excess of the permissable level. This was reduced to $415 million early in 1971 primarily by reducing the amounts previously budgeted for industrial materials, and a small cut in food imports. It is now estimated that merchandise imports in 1971 will total $405 million giving an import capacity of a little over $400 million, taking into account the balance on invisibles. During the first half of 1971, the industrial sector, including the public corporations, were able to maintain production by drawing down inventories and buying imported supplies on trade credit. In recent months, however, both means seem to have all but come to an end. European and U.K. suppliers are said to be requiring foreign bank guarantees of letters of credit and the Ceylon press is now characterising the situation as a crisis of major proportions. In the meantime the levels of food, textile, petroleum, fertilizer and certain essential raw material imports are being maintained from Ceylon's slender cash resources.

By the end of 1971 Ceylon expects to have maintained her merchandise import capacity at about the $400 million level of 1970. The estimated means of financing these imports compared to the 1970 capacity and the Bank's estimate in December, 1970 are shown in the following Table:

Financing of Merchandise Imports
(US $ million)

	1970	1971 (Bank Estimate)	1971 Revised
Own Resources	286	286	212
Medium and Long-term Credit	84	97	87
a. Commodity Aid	54	55-60	59
b. Project Aid and Other Aid	13	20-25	13
c. Suppliers Credit	16	17	15
d. Foreign Investment	1	-	-
Short-term Credit and Use of Reserves	32	-	107
a. Trade Credits	32	20	113
b. Borrowing from Banks Abroad	25)	- 20	- 11
c. Use of Reserves (inc. IMF & SDR's)	- 25)		5
Total = Merchandise Imports	402	383	405

The reason for the marked variation between the Bank's estimate of Ceylon's own resources to finance imports and the Governments current estimate is diversion of funds to repay the $100 million of short-term credits that fall due in 1971. The sharp reduction of project and other aid is due in part to cancellation of $18 million of Bank Group loans and credits and to the long delays in renegotiating the Maskelyia and Mahaweli projects.

The very large increase in estimated trade credits indicates not only that the Government did not accept the Bank's conclusion that she could not afford to permit short-term indebtedness to increase further but, more importantly, the Government's overall exchange policy has been to strain Ceylon's external credit position to the breaking point in order to finance higher levels of "essential" consumer goods. The evidence clearly indicates that this policy has been implemented at the expense of import of investment goods and productive inputs.

Ceylon's external financial position in 1971 would have been far worse, and possibly hopeless, had she not received an untied sterling currency loan from China amounting to $25 million equivalent. It is understood that part of this loan was used to pay the final installment of DM 15 million to KFW and that the balance has been or will be applied to maturing trade credits and short-term foreign bank obligations.

Short-term Credits

On the basis of projected imports during the second half of 1971 it is estimated that short-term trade credits and foreign bank loans outstanding to be carried over into 1972 will amount to $59 million and $27 million respectively. The total of $86 million will fall due in 1972 and unless the Government can find the resources to repay them or in some way reschedule, Ceylon's import capacity in 1972 will decline drastically.

Ceylon has recently had some success in rescheduling foreign bank credits. Agreement was reached on final repayment of the balance of the KFW loan, on which Ceylon defaulted in December, 1970, in two installments of DM 15 million each in March and June, 1971. The £ 8.5 million in loans from the British banks would have fallen due in December, 1971 but have been rescheduled over a 5-year period. Negotiations are continuing to reschedule the $5.0 million balance of the loan from Manufacturer's Hanover Trust which matured in July, 1971. The estimated $27 million of outstanding foreign bank loans is net of expected rescheduling and repayments in 1971.

As a condition of the 1971 standby agreement with the Fund Ceylon agreed that short-term trade credits would not be increased by more than $20 from the beginning of 1971 to the end of the standby period. As of January 1, 1971 total external short-term commercial debt amounted to $46 million which, together with the permitted $20 million increase, provides a ceiling of $66 million. Commercial short-term credit outstanding as of the end of August was $72 million, well above the ceiling. No further drawings under the standby are possible as long as the ceiling is exceeded. The Government estimates that outstanding trade credits will be reduced to $59 million by the end of the year.

Net Foreign Assets

During 1970 Ceylon's net foreign assets increased by only $12.6 million and liquid reserves were less than $5 million. Since then there has been considerable improvement in net assets as shown in the Table below:

Changes in Net Foreign Exchange Assets - August, 1971
(US$ million)

Central Bank Short-term Liabilities	26.5
Bilateral Trade Accounts	20.5
	47.0
All other accounts	- 2.0
Net Change	45.0

There has been no improvement in liquid balances, however, which remained below $4.5 million.

The Outlook for 1972

The Government's preliminary balance of payments forecast indicates that the outlook for 1972 is very grim indeed. Little improvement in export earnings is visualized and even assuming that all of the outstanding short-term bank and trade credits are rolled-over, import capacity in 1972 is expected to fall to $330 million from a level of about $400 million in 1970 and 1971.

There is some flexibility in this, however, since the 1972 payments forecast assumes that the $34 million legally due to the Fund will all be repaid in 1972. About $27 million of this must be repaid but the balance can be rescheduled over an additional two years. A new standby is also possible.

Although no breakdown of merchandise imports for 1972 is available it is likely that if a sizeable short fall of export capacity occurs, imports of investment goods and productive imports will bear the brunt of this, to the further detriment of domestic production, employment and growth. The principal elements of the estimated decline of import capacity include repayments to the IMF, less commodity aid and zero net increase of short-term credits. The forecast indicates repayment of $10 million of the outstanding foreign bank credits, indicating that the Government expects to roll-over the remaining $17 million.

THE 1970/71 BUDGET OUTLOOK

Current Account

The revised 1970/71 budget clearly indicates that the Government has been unable to contain current expenditures or to increase revenues as initially planned. The original budget showed a very small surplus of Rs 26 million on current account. The revised estimates indicate a deficit of Rs 353. This is accounted for by an increase of 9 percent in expenditures, a 4 percent decrease in revenues and unexpected advance account operations amounting to Rs 104 million.

The large increase in expenditures was the result mainly of larger outlays for food, refunding of FEECS and the current cost of the insurrection. The drop in estimated revenues was due to lower customs and tax collections, less income from the sale of FEECS and to substantial over-estimation of revenue from the demoneterization and compulsory savings schemes.

Capital Account and Budget Deficit

The revised estimate of capital expenditures is 14 percent below the original estimate. This is accounted for largely by under-utilization of project aid by 50 percent, failure to implement the crash employment program and lower expenditure on FEECS. Capital expenditures would have been about Rs 57 million lower had it not been for the purchase of military hardware.

The revised budget shows that the overall budget deficit is expected to increase by 20 percent over the original estimate to Rs 1426 million. Comparison of the original and revised budgets, including financing of the deficit, is shown in the following table: (over page)

ORIGINAL AND REVISED BUDGET[1/] ESTIMATES - 1970/71
(Rs million)

	1969/70 Prov.Actual	1970/71 Original	Revised
Revenue	2736	2878	2751
Current Expenditure (net)	2860	2842	3104
Current account surplus/deficit	- 124	36	- 353
Capital Expenditure	1026	1220	1073
Less: sinking funds & amotorization	214	249	255
net capital expenditures	812	971	818
Add: sinking funds & amotorization	214	249	255
	1026	1220	1073
Current act-surplus/deficit	- 124	36	- 353
Gross budget deficit	1150	1184	1426
Financing of the Deficit			
Non-bank borrowing	381	445	600
Project Aid and grants	110	113	67
Commodity Aid	234	525	325
Emergency Aid	-	-	35
Currency Loan (China)	-	-	100
Suppliers Credits	-	-	169 2/
Other	- 31	-	32
Expansionary Bank financing	454	101	98 3/
	1150	1184	1426

1/ Revised as of July 1, 1971
2/ Food imports - flour, sugar and rice'
3/ Collections under the compulsory savings scheme amounted to Rs 25 million. If available before September 30, bank borrowing will be reduced to Rs 73 million.

Financing of the Deficit

The reason for the sharp decline of commodity aid is not clear but it was probably over-estimated in the first place and may also be linked to the shortfall in estimated capital expenditures including under-utilization of project aid. The revised estimate indicates that nearly 25 percent of total financing of the deficit was from sources not visualized in the original budget; and this in turn indicates the ways in which Ceylon has struggled to maintain public financing. The great importance of the $25 million currency loan from China is again indicated in the revised estimates. Without it Ceylon could easily have again been in default.

Shifting of a sizeable part of food imports to suppliers credits has served to postpone cash payments. It is reported that these are mainly 18 month credits which conveniently avoids the Fund's ceiling on commercial credits of less than one year. However, the entire amount of suppliers credits falls due in 1972 and will have to be provided for in the next budget unless they can be rolled-over. When these obligations are added to the payments due on foreign bank and commercial trade credits in 1972 it seems apparent that Ceylon is at or near the end of the line as far as short-term financing is concerned. And with little prospect of increased project or commodity aid it is likely that the "crunch" may be near at hand. One may speculate on whether this would be good or bad for Ceylon and the answer would seem to depend on one's degree of faith that the Government will face up to these harsh realities without being forced to do so and successfully cope with them in both the short and longer-term periods.

In 1969/70 net public expansionary domestic financing soared to a total of Rs 454 as compared to Rs 249 in the previous financial year. The original ceiling agreed to with the Fund for 1970/71 was Rs 88 million, but this has since been increased to Rs 97 million as a result of net repayments during the year. If this ceiling is exceeded the current standby agreement will be automatically in default. A new ceiling would then have to negotiated, which could prove very difficult. According to official figures the Government has thus far stayed well within the permissable limit.

RICE

A recent report shows that total rice production in the 1971 crop year is expected to be nearly 20 percent below the level of output in 1970. The primary factors responsible are reported to be a drop of about 14 percent in yields and a decrease of about 100,000 acres in the area sown. These are both attributed to a combination of unfavourable weather, the insurgency, lower fertilizer usage and lack of credit. Other evidence suggests that an important underlying cause may be the institutional modifications the Government is making in the rice production program including reorganization of cooperatives and modification of the functions and authority of the district agents.

The report also estimates that rice imports in 1971 will be 40% less than in 1970 with a further decrease of nearly 25% projected for 1972. Larger purchases under the guaranteed price scheme is the main reason for these estimates but it is also expected that total rice consumption and total cereal consumption (rice plus flour) will drop by 12 and 8% respectively in 1971. There is no ready explanation for this unless it means that the Government has decided not to import the full quantities of rice and flour required to satisfy demand at current prices and to let the price mechanisms of the free market allocate those portions of the available supplies of rice not required to meet the rice ration.

CONCLUSIONS

The principal conclusions from this brief examination of Ceylon's economic performance in 1971 may be summarized as follows:

1. Import capacity has been maintained at about the 1970 level but only by straining Ceylon's credit position to the breaking point. This high price will somehow have to be paid in 1972, which promises to be a very grim year indeed.

2. Current expenditures increased by the record rate of 9 percent. To some extent this may be attributed to the cost of the insurgency but by far the largest part was due to increased imports of food and other consumer goods.

3. Current revenues were substantially below the orginal 1970/71 estimates due to lower custom and tax collections, lower FEEC sales and over-estimation of income from the demoneterization and compulsory savings schemes. It is now estimated that the budget deficit on current account in 1970/71 will amount to a staggering Rs 353 million.

4. Capital expenditures, which included considerable military hardware, remained at about the 1970 level but were well below the original 1970/71 estimate. Shortages of imported materials appear to have caused industrial production to fall sharply since June.

5. To help finance the exceptionally high budget deficit the Government continued to expand short-term commercial credit to the point where suppliers have refused further credit without foreign bank guarantees. The Government has had little success in making such arrangements and N.M. Perera will seek modification of this restriction when he meets with British and European bankers following the Annual Meeting.

6. Contributing to the need to import on commercial credit terms were large shortfalls from the original estimates of project and commodity aid. The way in which Bank Group loans and credits were handled and delays in negotiating commodity loans were in large part responsible.

7. Had it not been for the wind-fall currency loan from China in May Ceylon would have reached an acute crisis position much earlier. It does not seem likely that this will be repeated in 1972, although there are rumours that a second currency loan is under discussion.

8. The outlook for 1972 is, to say the least, most discouraging. Even under optimistic assumptions regarding rescheduling of commercial, foreign bank and suppliers credits Ceylon's import capacity in 1972 may not be much more than $330 million compared to about $400 million in 1970 and 1971. If this occurs, and given the Government's commitments to social welfare, it is more than likely that investment, growth and employment will be a heavy looser.

cc: Messrs. Votaw, Melmoth, Blobel, Baneth, Roulet & Kavalsky

ASCleveland:avm

CONFIDENTIAL

CEYLON COUNTRY PROGRAM PAPER

Postscript

41. The Ceylon Country Program Paper was reviewed at a meeting in Mr. McNamara's office on March 24, 1971. The following conclusions were reached:

(a) Ceylon faces extraordinarily difficult economic problems. Although these derive essentially from the decline of prices in its major export products, they also reflect the failure of Ceylon to adapt its economic and social policies to the fundamental change of its export position. As stated in paragraph 28 of the paper, the current liquidity crisis as well as the difficult longer term outlook, call for a far-reaching action of economic and social policies. This view is widely accepted among government officials but there is no indication as yet that the nature of the problems facing Ceylon is understood by the Cabinet, let alone that the Government is moving towards a program of action of the kind required. An acute crisis is likely to occur within the next few months. Such a crisis, and a consequential change in political alignments, may well have to precede the preparation of a meaningful program of action by the Government.

(b) As regards the Aid Group, its major members have said that they will attend the meeting at the end of April and appear generally inclined to help Ceylon. However, the continuing existence of the Group and perhaps even the willingness of members to pledge at the next meeting will depend on the Government preparing a program of action - and demonstrating its ability to carry it out - that promises to see Ceylon through the present difficulties and back on to the path of development.

(c) As regards future Bank Group activities: (i) future lending will be limited to IDA as Ceylon can no longer be considered creditworthy for Bank loans; (ii) in the present circumstances IDA lending should be directed towards program type operations. Agriculture has top priority and steps should be taken immediately to identify possibilities for IDA to assist in expanding production for export and for import substitution. Should the Government request IDA assistance in the form of industrial import or similar program financing, the matter should be considered further, but IDA should take no initiative in this direction; (iii) pending clarification of Ceylon's economic policies and investment priorities further work on the other projects listed in the FY 1972 program, including the proposed education project, should be suspended; (iv) as proposed in paragraph 35 of the paper, conditions for IDA lending, in terms of Government action, should initially be set considerably below the ideal; (v) once these conditions are met, IDA may be able to lend to Ceylon more than its present tentative allocation in the order of $10 to 15 million annually.

(d) The Bank's approach to Ceylon should be reviewed in a few months, or earlier if warranted by a significant change in the situation.

South Asia Department
March 31, 1971

CONFIDENTIAL
3/19/1971

CEYLON - COUNTRY PROGRAM PAPER

		Bank/IDA Lending ($ millions)		
		1964-68	1969-73	1972-76
1970 Population: 12.6 million	IBRD /1	2.8	32.5	-
1969 per cap. GNP (in $): 157 /2	IDA /1	2.0	47.6	75.0
Current Population Growth Rate: 2.3%	Total	4.8	80.1	75.0
Current Exchange Rate: US$1 = Rs. 5.95 (parity rate) = Rs. 9.2 (rate covering 50-60% of payments)	Operations Program:		87.1 3/	122.0 3/
		Annual Average per capita ($)		
	IBRD/IDA	0.08	1.27	1.19
	IDA	0.03	0.75	1.19

/1 Net of cancellations

/2 $196 according to the concept used in the World Bank Atlas

/3 Operations program approved last year for 1969-73 was $174.3 million. Operations program for 1972-76 is notional.

A. INTRODUCTION

1. The major recent event on Ceylon's political scene has been the victory of the coalition led by Mrs. Bandaranaike in the general elections last May which gave it control over more than three-quarters of the seats, with Mrs. Bandaranaike's own party, the Sri Lanka Freedom Party (SLFP) holding nearly two-thirds. The United National Party (UNP) led by Mr. Dudley Senanayake, which had been in power since 1965, was left with 18 seats out of 157.

2. During the campaign, the coalition had announced its intention to bring about fundamental changes in economic organization designed to lay the foundation of a socialist society. To do this, it promised to give the leading role to the public sector and to bring the private sector under control, including in some cases through nationalization. Furthermore, it accused the previous administration of having pursued growth without regard for distributive justice and undertook, if elected, to implement a welfare-oriented program in which the most

popular measure was the re-establishment of the full rice ration which had been halved by the Senanayake government in 1966. On the external front, the coalition accused the Senanayake regime of having sold out to the West and claimed that Ceylon's sovereignty was being impaired by improper deference to the wishes of the West. The IMF and IBRD were branded as prime culprits and the Aid Group as an instrument of western imperialism. The coalition promised to reassert Ceylon's independence.

3. Shortly after coming to power, the new Government took various steps to fulfil its electoral promises. To begin with, it extended diplomatic recognition to certain eastern regimes (Hanoi, East Germany, etc.); this was done in such a way that it had the effect of annoying the main aid givers. With respect to the Bank, it established enquiry committees to review the three major Bank-financed projects (highways, power, and Mahaweli), while debate continued between those who wished to cancel all pending projects and those who advocated a more moderate course.

4. The Prime Minister and some of her advisers soon realized, however, that their expectations of securing from the eastern bloc or from mainland China the kind and amount of aid which Ceylon had been receiving from the Aid Group were unrealistic. They also realized that Ceylon could not do without foreign assistance. Less than a week after having assumed office, Dr. N.M. Perera, the new Minister of Finance and leader of one of the coalition parties, announced to the nation that he had inherited a financially nearly bankrupt country. Although the gravity of the situation became more generally understood only later - particularly in December 1970 when Ceylon defaulted on a loan from German banks - this discovery dampened somewhat the euphoria of the electoral victory and marked the beginning of a sobering process. To be fair, one has to recognize that to a large extent the difficulty had been the result of action by the previous Government. In addition, the previous Government, which knew the facts, had carefully concealed them in an attempt to win the election. In these circumstances it is not surprising that when the new Government was faced with the facts a good deal of confusion followed - which to a large extent still prevails today - as to what action it should and could take.

5. During the review of Ceylon's CPP in February of last year, there was no doubt that Ceylon's balance of payments was one of the major causes for concern. It was recognized, however, that while the situation called for far-reaching political decisions, little was likely to be done before the elections. It was agreed that the question should be taken up with the new Government soon after the elections, and that the Bank's lending program should be reviewed in the light of these discussions. In fact, the situation continued to deteriorate throughout 1970. A good deal of short-term borrowing was incurred in the months preceeding the elections despite our warnings and without our knowledge. Today, Ceylon's liquidity crisis is the overwhelming factor and all other issues, however important they may be, are secondary. It is therefore to this problem and to what the Bank should do in the circumstances, that the main thrust of this paper will be devoted. Since several constraints, however, are largely

the product of policies pursued by previous governments, it may be useful first to put Ceylon's problem in historical perspective by recalling some of the major events of Ceylon's recent economic history. This will be the object of the next section.

B. A BRIEF ECONOMIC HISTORY (1956 - 1970)

6. Since the mid-1950's Ceylon has been going through a painful process of profound social, political, and economic change. Its beginning was marked by the victory in the 1956 general elections of the Sri Lanka Freedom Party (SLFP) - then led by Mr. Bandaranaike and subsequently by his wife after his assassination in 1959. This constituted the first step towards eliminating the social, cultural, political and economic features of colonial rule which the United National Party (UNP) - representing the thoroughly westernized, English-speaking elite and middle class - had left largely untouched in its nine years in office since independence. The mid-1950's also saw the start of the decline in the prices of Ceylon's major export crops - tea, rubber and coconut products - which dominated the economy and had traditionally provided the Ceylonese with a per-capita income far above that of the rest of the Indian sub-continent. At the same time, Ceylon's population began growing rapidly largely as a result of successful efforts to eradicate malaria.

7. Social and political reform dominated the first ten years of this period. It led to the introduction of Sinhala as the official language to ensure that administrators could communicate with those they administered, and changes in the education system to place greater emphasis to Singhalese culture. It entailed the conclusion of an agreement with India on the repatriation of about half of the Indian labor force on the tea estates. But above all, it involved an acceleration of the program to reduce inequality of income and provide every Ceylonese with a minimum standard of living. Specifically, it meant increases in taxes, particularly on exports and the higher income groups, a continuance of the rice subsidy and the rapid expansion of a wide array of other consumer subsidies on a steadily widening range of other basic consumer goods and increased expenditures on free or heavily subsidized government services (not only free education but also health services and subsidized public transport). Finally, it meant sharp curtailment of the scope for private economic activity and corresponding expansion of the public sector (particularly in manufacturing), partly because of the Government's socialist orientation, but also because the private sector has traditionally been dominated by non-Sinhalese.

8. Undoubtedly, reforms were needed to create a society with an identity of its own, rather than an amalgam of communal groups governed by a Westernized elite. However, in the short run a heavy price was paid. Ethnic tensions ran high. The quality of the edcuation system and of administration deteriorated. The Government's social program resulted in large budget deficits which fuelled rapid expansion of purchasing power. At the same time, real income grew only

very slowly - partly, because public investment, which increased substantially, yielded little productive return as here, too, welfare objectives dominated over economic considerations; partly, because with declining export prices, particularly of tea, real income from export agriculture stagnated; and partly, because out of welfare considerations the Government kept the supply of imported consumer goods, especially foodstuffs, relatively plentiful and at low prices which offered little incentive to domestic production. Thus, a wide gap opened between exchange earnings and payments. External assistance was negligible because Government policies had alienated Western aid givers and aid from Communist countries, although sizeable in terms of commitments, was very slow in being disbursed. Thus, financing of the deficit fell largely on Ceylon's exchange reserves which, though substantial in the mid-1950's, ($236 million equivalent in 1956) dwindled rapidly and were virtually exhausted by 1961.

9. Although the Government then began to recognize the need to expand domestic production, its actions were very largely confined to palliative measures, in particular increasingly comprehensive and severe exchange in import controls. However, even these measures proved inadequate to prevent the exchange situation from deteriorating to the point where, in order to maintain imports of foodstuffs which the Government considered essential, imports of intermediate and capital goods had to be cut, thus further circumscribing the scope for developing domestic production. It was in this atmosphere of economic crisis that general elections were held in March 1965, following a Government defeat in Parliament over an attempt to nationalize the press which had become strongly critical of Government policy.

10. The government elected in 1965, led by Mr. Dudley Senanayeke, was faced with the task of bringing about major structural changes. However, it was also clear by that time that Ceylon's exchange situation had reached a point where sizeable external assistance was a precondition of any attempt to tackle the problems. The Bank had begun discussions in the last months of the previous Government on how this assistance might be mobilized. This led to the creation of the Ceylon Aid Group - presently consisting of Australia, Canada, France, Germany, Japan, United Kingdom and the United States, with observers from Denmark, India and Italy and representatives from the IMF, the Asian Development Bank, UNDP and OECD - which held its first meeting under the chairmanship of the Bank, shortly after the UNP came to power. It was hoped that an inflow of quick-disbursing commodity aid would allow the Government sufficient room for maneuver to permit some liberalization of imports for investment purposes and to restructure the framework of economic policies and thus begin the task of reversing the adverse trend. The situation appeared to call for three main lines of action: (a) curtailment of the growth of consumer demand so as to relieve the pressure on imported and locally produced goods; (b) reduction of the quantity of imported consumption goods, and thus release the foreign exchange resources required to reverse the decline of investment; (c) an increase in the volume and, particularly, the quality of investment so as to increase the rate of growth. From the aid donors it was hoped that a sufficient level of assistance would be provided over a period of several years to provide the Government with the room for maneuver for

implementing, without an absolute cut in consumption standards, the production, consumption and fiscal policies needed to achieve more rapid growth.

11. In this task of restructuring the economy, substantial progress was made between 1965 and 1969, as policy changes over a fairly wide front - in which the Bank took an active advisory role - provided an important stimulus to increased domestic production. Most notable among these changes were the halving of the rice ration in December 1966 and the reform of the exchange system. The former led to a sharp increase in the domestic price of rice and a substantial widening of the free market which were important factors in the rapid increase in production which took place. The rupee was devalued in November 1967 from 4.76 to 5.95 to the dollar. Further partial devaluation resulted from the introduction, in May 1968, of Foreign Exchange Entitlement Certificates (FEEC's). Their price was eventually fixed at a premium of 55 percent of the official rate, for an effective rate of exchange of Rs. 9.20 to the dollar, and the categories of payments subject to FEEC's were gradually extended. A category of Open General License imports was introduced, covering in particular industrial materials. These reforms had marked beneficial effects on economic activities, especially in manufacturing, and improvements in policies, combined with efforts to make existing investments more productive, brought about considerable acceleration of economic growth. In 1968 GDP at constant prices increased by about 8 percent and continued gains in agricultural and industrial production were recorded in 1969 when GDP increased by a further 6 percent, as compared to an average of 3.6 percent in the first half of the 1960's. In addition, after years of stagnation fixed investment increased considerably, from below 15 percent of GDP to 19 percent in 1969.

12. In contrast to the progress made in restructuring the produotive side of the economy, the management of financial affairs failed to provide the basis for sustaining this progress. At the outset, it should be noted that this task turned out to be much more difficult than had been expected when plans for economic improvement were mapped out in 1965. It was then expected that over the next five years export earnings would at least be maintained at their 1965 level. Consequently, aid would be translated into increased imports. In this context, the task of financial management was seen as ensuring that, initially, these increases in total imports and, subsequently, the fruits of rising domestic production, especially of food, went into additional imports of productive goods so as to initiate and then sustain the growth and restructuring of the economy. As it turned out, prices of Ceylon's major exports, particularly tea, fell much more rapidly than had been expected. Actual export earnings in 1966-1970 were in the aggregate $345 million less than they would have been had they remained at their 1965 level. In contrast, total disbursements by the Aid Group came to less than $250 million. Moreover, the rise in freight rates following the closure of the Suez canal and sharp increases in world prices of rice further eroded Ceylon's import capacity. In short, the foreign exchange constraint was immeasurably greater than had been expected.

13. The Government was not able to cope with the situation. Rising incomes went largely into increased consumption. Thus the increase in investment was financed largely by capital inflows. Interest rates remained low and, despite substantial increase in Government revenues, the Government's current expenditures rose just as rapidly, since the maintenance of social and welfare

programs required increasing resources. Rising money incomes, in the absence of adequate tax and savings policies, put added pressure on the balance of payments.

14. By 1968 the strain of attempting to maintain import capacity for both investment and consumer goods in this context had begun to show. In that year large drawings on the IMF and sizeable supplier's credits were required to finance a level of total imports only equal to that of 1959. In 1969, however, further drawings on the IMF were not possible and Ceylon's import capacity declined below the level of 1968. Despite this, imports were allowed to increase substantially. The principal reason was that, in anticipation of the general elections, the Government failed to translate increases in domestic production, particularly of food, into reductions in imports. Furthermore, at a fixed FEEC rate, demand for imports under open general licences began to outrun available foreign exchange. To finance the increase in imports external reserves were exhausted and large amounts of short-term high-interest foreign commercial bank credit were drawn to meet exchange payments. Ceylon thus entered 1970 with a severely weakened liquidity position.

15. Unfortunately, further deterioration did occur. The 1970 import budget which was well in excess of import capacity was not cut back before the elections in late May. Exports in the first half of 1970 remained at the 1969 level instead of increasing as expected and short-term indebtedness to foreign commercial banks increased still further. Domestic financial policies also served to keep import demand at a high level. Expansionary financing reached high levels in 1969/70 and rising prices produced political pressure for reducing the cost of living. Thus when the present Government came to power in mid-1970, it was faced with the worst foreign exchange crisis since the war, and a potential internal financial situation of similar gravity. On coming to power in May 1970 the new government under Mrs. Bandaranaike articulated a number of political objectives, in particular to redistribute income, reduce the cost of living and increase employment. A variety of actions have been taken in pursuit of these objectives. These include the restoration of the second measure of rice to the ration; the extension of price controls to a growing list of manufactures; the limitation of the area of private sector industrial activity; progressive nationalization of wholesale and foreign trade; and the formulation of an employment program.

16. Ceylon is faced with a situation where the total supply of goods from overseas must be curtailed in the short-term and where, over the longer term, the government must seek to achieve its economic objectives within a more or less constant level of imports. If the economy is to continue to invest so as to achieve growth of domestic production and employment, with roughly stable prices, then the primary policy objectives must be to limit the growth of consumer expenditures and to increase public and private savings. Total savings in Ceylon have fallen from almost 16 percent of GNP in 1961 to about 12-1/2 percent in 1969, and, if preliminary estimates are accurate, to under 11 percent in 1970. In the present political climate private savings must be expected to decline. The weight of action therefore falls to the government, which must increase savings by increasing its tax revenues relative to its consumption.

17. Seen against this background of the urgent need to increase public savings, the 1970/71 budget is a disappointing document. Even the original budget estimates show a fall in the surplus of revenues over current expenditures from Rs. 161 million to Rs. 77 million. These earlier estimates have been overtaken by events, however, which strongly suggest that this budget will not only fail to provide a way out of the present difficulty, but will in fact lead to further deterioration. A series of revisions to the original budget estimate have had to be made for a variety of reasons, which in sum represent a serious worsening of the budgetary situation even as compared to the very unsatisfactory outturn last year. It is difficult to see how the deficit could be significantly reduced without virtually eliminating public investment.

18. In his budget speech, the Minister of Finance talked of the government's objectives. "It is committed", he said, "to maintain those social welfare measures which are an integral part of our fabric and to take all such steps as the situation demands to provide the necessities of life at reasonable prices to the mass of our people. It is committed to a program of rapid economic growth of sufficient magnitude to absorb a sizeable proportion of the unemployed and to bring the solution of this problem within sight during its term of office". He added, "The magnitude of our development effort, the rapidity with which we can increase the production of these goods and services upon which our general welfare depends and the speed at which we can effect the transformation to socialistic forms are determined by the extent to which we are willing to make a sacrifice now and the extent to which we are willing to increase our productive work." Insofar as new directions have been set these have not been towards growth. None of the measures taken so far can be represented as a sacrifice of present consumption for future benefits. Consumption in 1970 grew at a faster rate than GNP and the prospects are for a similar divergence in 1971.

C. THE FOREIGN EXCHANGE CRISIS

19. Ceylon is presently facing the most severe external payments problem since the war. At the beginning of the last decade, the country still held US$100 million in official exchange assets, unencumbered by short-term liabilities. By the end of 1970, these assets had shrunk to US$42 million, of which more than half is either in bilateral balances that cannot be used readily or in securities that have a market value considerably below book value and in any event are pledged against borrowings. At the same time, US$67 million of short-term debt was owed to commercial banks abroad and short-term trade credits stood at about US$60 million. Outstanding drawings on the IMF amounted to a further US$88 million, making the Fund's holding of currency in Ceylon the largest among its members in relation to quota.

20. The Central Bank's liquidity position is extremely weak. Its liquid assets are below US$5 million. Among the various lines of credit with commercial banks abroad, which during the previous two years had in effect served

as the Central Bank's working balances, little is left to be drawn. Altogether, therefore, the Central Bank has less than US$10 million in liquid resources with which to conduct the external finances of a country with an annual volume of exchange payments in the order of $400 million. In the circumstances, even small unexpected payments present problems; large ones can cause a major crisis.

21. Looking ahead, one can only conclude that in 1971 Ceylon's external payments difficulties will become more rather than less intense. Most agreements with the commercial banks abroad expire in the first seven months of the year; unless they are renewed, sizeable net repayments will have to be made in the course of the year. In addition, short-term trade credits of US$60 million will fall due, and the repayments of US$24.5 million will have to be made to the IMF during the calendar year. Together, those obligations come to about US$150 million. Payments on trade credits presumably can be offset by new borrowing. Under a new stand-by for US$24.5 million from the IMF, approved by the IMF Board on March 17, Ceylon will receive $19.5 million in 1971. However, financing will have to be found for nearly $70 million - an amount equivalent to a fifth of a year's estimated earnings from merchandise exports and about twice Ceylon's official external assets. It is obvious that Ceylon's external financial position in 1971 will be unmanageable unless an accommodation is reached with the creditors that would substantially reduce payments falling due that year. The agreement with the IMF may well facilitate negotiations with commercial banks abroad. It is understood that the Ceylonese authorities have initiated discussions with some of the banks concerned to seek conversion of short-term loans into medium-term ones (5-8 years).

22. Accommodation with all the short-term creditors would render more manageable the task facing the authorities in avoiding a crisis. However, it would still leave Ceylon in a critically weak liquidity position. There is no question that the Central Bank's liquid assets must be increased. To this end, an amount at least equivalent to this year's allocation in SDR's of US$11 million should probably be set aside. In addition, the commercial banks may well insist on Ceylon reducing its obligations to them somewhat - say, by US$10 million. If, finally, Ceylon decided not to incur any net additions to the short-term trade credits outstanding at the end of 1970, net movements in short-term liabilities and assets would this year absorb nearly US$10 million in exchange resources. This would be in contrast to Ceylon drawing on this source to the extent of US$31 million in 1970 and US$58 million in 1969 for financing merchandise imports.

23. There is no prospect of any significant increase in exchange earnings in 1971. Judging by undisbursed commitments of external assistance in the pipeline, disbursements this year are unlikely to exceed US$80 million - US$25 million in project aid and US$55 million in commodity aid. At this level, they would exceed last year's receipts by about US$15 million. Unless it can be increased by additional assistance, a balance of payments policy directed towards rebuilding Ceylon's liquidity position will have grave consequences for the amount of imports Ceylon can afford in 1971. Rough estimates suggest that, with the resources in sight, merchandise imports this year will have to be kept down to roughly US$375 million, US$30 million less than in 1970 and as much as US$70 million below the level of 1969.

24. The fact that at US$375 million imports would be at their lowest level since the late 1950's underscores the sharpness of the conflict between the need for improving the liquidity position, the import demand associated with current levels of consumption and the import requirements of economic growth with which the Ceylonese authorities will have to struggle in 1971. Clearly, the present liquidity crisis is merely the most glaring symptom of a much deeper malady.

25. More than a decade after the prices of Ceylon's major exports (tea, rubber and coconut) began to weaken and, consequently, total exchange earnings first became stagnant and then declined, (about $370 million annually between 1954 and 1965, against about $340 million for the period 1966-1970), Ceylon's imports, as is particularly evident in the continuing dominance of food imports, still have the basic structural characteristics of an export economy. Fundamentally, this situation reflects the inability of successive Governments to reconcile the longer term needs of the economy for structural adaption, through growth of domestic production, to the basic change in the export position, with strong pressures for current consumption. To effect such a reconciliation, within a level of imports Ceylon can afford and on terms that will dispel the prospect of long-term economic decline, is the fundamental challenge facing the present Government. This task by itself would have been a difficult one. As it is, it also has to deal with a liquidity crisis that is not of its own making.

26. It is evident from the discussion that at present a wide discrepancy exists between the direction which Government economic policy appears to be taking and that which it should be taking if Ceylon's economic affairs were to be managed effectively in the current difficult situation. In the circumstances it is obviously not possible now to reach any substantive conclusions about the prospects for economic and social development in Ceylon, except the negative one that without a major redirection of policy all indications point to long-term economic decline. However, instead of dwelling on the dire consequences of inaction on the part of the Government, it may be more appropriate briefly to summarize what appear to be the two critical elements in any effort to overcome Ceylon's severe difficulties and set it on the path to economic improvement.

27. One such element is (1) external assistance. There is no question of the Government being able to cope with the present difficulties on its own, without continuing support from abroad on a substantial scale. Any appreciable shortfall, for any length of time, in imports below US$400 million will threaten to strain beyond tolerable limits the Government's capacity for curtailing domestic consumption. Yet, without fresh commitments of aid, Ceylon's import capacity will fall to about US$330 million in 1972 and thereafter level off around US$300 million. Thus, it is essential that disbursements of aid be at least maintained at their estimated level of US$80 million in 1971. Moreover, they will have to continue at this level not just for a couple of years, but for some time to come. These may seem large numbers for a country with a population of 12-13 million and it will certainly be difficult to mobilize external

assistance in such amounts, although it is a sobering thought that all the aid Ceylon received during the past five years did not make for the loss of exchange earnings that resulted largely from the decline in prices of its major export products.

28. However, for all its easily demonstrable need for external assistance, Ceylon would be unrealistic in expecting to obtain aid in amounts anywhere near those mentioned above, unless the Government establishes a policy framework to support a structural transformation of the economy to setting Ceylon on the path to development. The establishment of such a framework is, therefore, an equally important element in a renewed effort to overcome the structural difficulties of Ceylon's economy. Such a framework must provide for strong emphasis on promoting rapid growth of agricultural production, while industrial development, because of the large demands for imports associated with it, must probably for the time being be kept to a minor role. It must point the way to more efficient use of existing productive assets, particularly in the public sector which will require, inter alia, higher productivity of labor and more effective management. Finally, it must enable the Government to curtail the growth of consumption, private and public together, to the point where the major share in the additional income generated over the next several years is channeled into savings and reductions in imports of consumer goods, including food. Altogether, these various elements of a viable framework of domestic economic policies amount to a formidable challenge to the perseverance and ingenuity of the Government whose magnitude it is difficult to exaggerate.

29. If it were to meet this challenge, the Government would, in essence, not only have to go back on its principal campaign pledge of improving the standard of living of the masses, but would also have to break with the country's long-standing tradition of the State subsidizing many essential consumer goods and providing a wide array of free or heavily subsidized public services. It is far from certain that it will be able to muster the will and have the strength for carrying such a program through. In our concluding discussions, at the end of the economic mission last December, with the Prime Minister, our analysis of the facts of the situation was received with a good deal of disbelief, although officials generally agreed with the position we were taking. We therefore sent a note summarizing our findings and conclusions to the Government, preparatory to a further round of discussions towards the end of February. During the second visit, it appeared that in the intervening months realization of the difficulties in which Ceylon found itself had grown, aided no doubt by the fact that shortages of essential imported consumer goods had begun to appear in the market. However, there was as yet no semblance of a plan for action, either with respect to this year's exchange budget and import program or the Government budget, let alone a broad strategy for development. Indeed, there was no indication that any of these matters had come before the Cabinet. The Prime Minister, while recognizing the need for action, gave no indication that she intends to press the matter, possibly because she is uncertain whether she will be able to carry with her the left-wing elements in her coalition, including those of her own party. We impressed upon the Government the need for their being able in broad terms to

indicate to the Aid Group at their meeting at the end of April how they proposed to extricate the economy from its current severe difficulties and to present some evidence of concrete action, but it remains to be seen whether any decisions will have been taken by that time.

D. THE BANK/IDA PLAN

30. For the time being, the role, which the Bank Group will be able to play in Ceylon, must be regarded as quite uncertain. Most predominantly, it will depend upon the evolution of the political situation in the country. While the Government, as presently constituted, recognizes that circumstances argue strongly for further collaboration with the Bank, some groups among the coalition parties would like to see Ceylon cut its links with the western world and with institutions like the Bank which has often been identified with western capitalism. Should these take over the Government, the role of the Bank Group would presumably dwindle to that of an unpopular creditor. On the economic and financial front, much will depend upon the measures which the Government will take to tackle the country's external and internal liquidy crisis and to achieve some degree of development.

31. Last year's Country Program Paper commented that if a government led by Mrs. Bandaranaike were to come to power, there would be a period of confusion while officials tried to convince the new Ministers that Ceylon has little room for maneuvre. This prediction has now come true. At present, there is still a good deal of confusion and the process of education of the new leaders is far from complete. Although the euphoria and flamboyant attitudes of last summer have been replaced by a somewhat more sober posture, no meaningful action has yet been taken. Appropriate fiscal and economic policies still have to be devised.

32. Since last June we have had several rounds of discussions with government officials and in this process opinions and attitudes toward the Bank have changed somewhat. The mere fact that the Bank has been willing to listen to objections to its three major projects, however justified or unjustified they may have been, came to many as a surprise, as was the discovery by some of the new officials that the Bank had also been critical of the previous regime. In view of the divergent attitudes towards the Bank among the different partners in the coalition, however, the vaudeville episode of the letters cancelling and then uncancelling our loans last July, may be repeated in one form or another. Nonetheless it is hoped that some degree of improvement will in the end be achieved. One of the Bank's objectives should therefore be to keep in contact with Government to assist in devising sensible economic policies, although given the magnitude of the problems, it is impossible to say what the outcome of a continuing dialogue will be.

33. The second field in which the Bank should remain active is that of the Aid Group which the Bank has shared since the Group was created in 1965. Obviously the continuence of the Aid Group does not depend upon the Bank but

upon each of the participants and in this respect the initiative rests primarily with Ceylon. So far, the major contributors have indicated that provided Ceylon does not take further diplomatic initiatives embarrassing to them, ceases threatening foreign interests and adopts policies aimed at achieving a reasonable degree of growth, they would be prepared to continue participating in the Aid Group. On the first two points there is of course little, if anything, that the Bank can do, but with respect to economic policy the Aid Group will be looking to the Bank for an objective appraisal of the situation. In the absence of new policy initiatives, we are now obviously not in a position to present a case for continuing assistance on the basis of economic performance. Nevertheless, we propose to have the Aid Group meet at the end of April, and expect that it will be responsive, on the grounds that a suspension of assistance (which finances over 20 percent of Ceylon's imports) would plunge Ceylon into a crisis of disastrous proportions and that for political reasons most members would probably want to avoid the impression that creation of the Aid Group was solely the reward for the election of a "friendly" Government.

34. The third area of importance is the Bank Group's own lending program. Here, the first question is obviously: should the Bank Group lend at all to Ceylon? Last year's Country Program Paper sounded a strong note of caution particularly with regard to Ceylon's ability to continue borrowing from the Bank. While the paper stressed that the bulk of assistance should come from IDA, it argued that under certain optimistic assumptions, a substantial amount could still be borrowed from the Bank over the next five years. It concluded, however, that if any of these assumptions did not prove true, it would be necessary to scale down Bank lending. None of the optimistic assumptions have become a reality, and many of the pessimistic ones have become true. Today, Ceylon can no longer be regarded as creditworthy for new Bank loans. Indeed, a certain reduction in the Bank's exposure would be desirable and in this respect the cancellations of the highway loan (569-CE) of $4.9 million, of $4 million under the last power loan (636-CE), and of about $1.2 million from the first DFCC loan (520-CE) are welcome. A further cancellation of up to $7 million is expected from the second DFCC loan (634-CE). Altogether, this will have the effect of reducing the Bank's present commitments from $76.3 million to $59.2 million. Assuming no further Bank lending and taking into account the pace of future disbursements and repayments, the Bank's exposure which today amounts to $25.3 million will not exceed $45.4 million (by 1975).

35. Fresh Bank Group assistance will thus have to come entirely from IDA. The question here is under what circumstances would we consider Ceylon eligible for IDA financing. As explained earlier, unless the Government is prepared to establish a policy framework designed to set Ceylon back on the path of development, all indications point to economic decline. In such a situation, there would probably be no justification for lending both on general performance grounds and also because Ceylon would then most likely not have any rupee resources to cover even a modest share of project costs. On the other hand, if we were to make IDA lending contingent upon the Government having introduced the kind of comprehensive policy package which ideally it should undertake to overcome the present difficulties, there would most

likely be no IDA lending for the next several years. It is proposed that, initially at least, we set the conditions for IDA lending considerably below this ideal and indicate to the Government our willingness to lend when there is evidence that the Government has faced up to the facts of the situation, agreement has been reached within the Government on a broad strategy for setting the economy back on the path of development, and some significant concrete steps have been taken towards putting the strategy into effect (for example, formulation of a supplementary budget and of a realistic import program that does not place the entire burden of adjustment on investments In our discussions in February, we urged the Government to take action along those lines before the meeting of the Aid Group at the end of April. It remains to be seen whether they will do so.

36. Assuming we can continue lending, we should in present circumstances - and taking among other things account of the fact that Bank Group net transfers with Ceylon have been negative for several years - essentially look for projects which would:

(a) lead to quick disbursements;

(b) finance essential items expected to be imported even without financial assistance; and

(c) provide support for the required redirection of economic activity and Government policies.

All this points towards some form of program lending as the most suitable action. The major problem is, however, that the Government's overall policies might make it difficult to justify a program loan. Also, much of the Aid Group assistance takes the "non-project" form and may thus pre-empt areas which could otherwise be considered for IDA assistance. On the other hand, under certain circumstances it might be possible to devise sectoral loans which would meet urgent requirements in Ceylon's development program.

37. The first sector to be explored is agriculture. Given Ceylon's balance of payments situation, there is no doubt that high priority must be given to agriculture where there is still considerable room for increasing production for export as well as for import substitution. Bank Group lending to Ceylon in the past few years has reflected this priority. In addition to the Mahaweli project, two smaller projects, for irrigation and land reclamation, which were the results of an identification mission organized in 1966, are now being carried out. In the years ahead, a good deal of attention will have to be devoted to their supervision, which may lead to preparation of further similar projects. However, we should now look into the possibility of devising a scheme to increase production of export crops such as rubber, coconut, cashew, pepper, and/or cocoa. Such a program could have a quick impact on Ceylon's foreign exchange position and might well include financing current inputs (such as fertilizer) over a given period of time. Similar assistance may be possible in support of the Govennment's program to expand production of rice and other foodstuffs to reduce imports. The difficulty of such a scheme is that while we have some broad knowledge of Ceylon's requirements, it is not specific enough. Therefore as a first step we are planning

to organize an identification mission, hopefully within the next few months, in order to select elements that appear feasible and to outline whatever further steps should be taken. Another sectoral credit could possibly be devised in the field of transportation. For example, should the Government finally decide to raise bus fares, especially in Colombo, so as to make its Transport Board a viable enterprise, one could consider financing the modernization of Ceylon's bus fleet for which the Government is annually spending substantial amounts of foreign exchange to keep obsolete equipment running. Such a credit could also possibly include some assistance for the railways' maintenance and improvement program, including track renewal. Here again, the first step will be to send a mission to Ceylon to identify items suitable for financing.

38. Although these projects should be given high priority, their preparation may run into difficulties and may turn out to be time consuming. Consequently, preparation of the more conventional projects that are already in the program will continue. This means essentially Education where much work has already gone into project preparation since 1968. Last month a UNESCO preparation mission, under the Cooperative Programme, visited Ceylon to assist the Government in preparing a request for financing. This mission has now completed its task and an advance copy of the request was received a few days ago. Appraisal is presently scheduled for mid-April. Because of the Government's budgetary difficulty, there is a need to reduce the program which, as proposed, is too large. The request will have to be considered carefully to keep only elements which would have sufficient priority to warrant financing now. This should be possible, particularly in such fields as agricultural, technical, and vocational education. There is also a Highway project resulting from the Government's intention to devise an alternative to the project recently cancelled. With respect to Power, the Government had originally hoped to use savings under Loan 636-CE to finance its transmission needs. We understand that a request for financing is under preparation, which may be suitable for IDA and/or bilateral financing.

39. In view of the above, the program outlined in Attachment I should be regarded as notional. In present circumstances we shall first of all endeavour to identify new projects which would meet the criteria in paragraph 36 while continuing preparation of those already identified. For planning purposes, we propose to treat the next two fiscal years as a single period and, while making all the necessary reservations, intend to inform the Government representatives at the time of the Aid Group meeting, that IDA would be prepared to consider making credits totalling about $25 - $30 million over the next two fiscal years and that in our opinion all attempts should be made to have these channelled through sector-type operations. Assuming a favorable answer, the missions mentioned above should be sent shortly thereafter to identify the projects. Given the advanced stage of preparation of the education project, the timing of the appraisal mission should, if at all possible, be kept unchanged.

40. Regarding assistance beyond FY 73, the situation will have to be kept under review and as it evolves specific proposals will be made. One may expect, however, that agriculture and possibly industry will require further assistance. Regarding Agriculture, arrangements are presently being made - as suggested last year - to organize a sector mission to review Ceylon's

longer-term prospects and needs. In reply to a request from ILO to participate in a mission to be led by Professor Seers from March 25 through the end of May to assist Ceylon in devising an employment strategy, the Bank has agreed to make available two staff members to look into the industrial sector. Although the report itself will be the responsibility of Professor Seers, information collected during the mission might suggest ways for subsequent Bank Group assistance.

South Asia Department

March 19, 1971

Population: 12.6 m
Per Cap Inc: $157

CEYLON - ACTUAL AND PROPOSED LENDING THROUGH FY1976
($ millions)

Attachment 1

		Through 1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	Total 1964-68	Total 1969-73	Total 1972-76
Lift Irrigation	IDA						2.0											
Drainage & Land Reclamation	IDA								2.5									
Mahaweli Irrigation I	IBRD								14.5									
~~Mahaweli Irrigation I~~	IDA								14.5									
Mahaweli Irrigation II	IDA													25.0				
Agriculture (Sectoral Credit)	IDA											15.0						
Livestock	IDA													5.0				
Agriculture - Unidentified	IDA														10.0			
DFCC I	IBRD						2.8*											
DFCC II	IBRD								1.0 2/									
Education I	IDA										5.0							
Education II	IDA													5.0				
Power I	IBRD	19.1																
Power II	IBRD	7.4																
Power III	IBRD	15.0																
Power IV Maskeliya Oya	IBRD								17.0*									
Power Transmission I	IDA										7.0							
Power Generation	IDA												10.0 3/					
Highways I	IDA							0.6*										
Highways II	IDA										10.0							
Highways III	IDA												10.0					
Transportation - Unidentified	IDA														10.0			
Industry - Unidentified	IDA												5.0					
Industry - Unidentified	IDA														5.0			
Operations Program	IBRD										-	-	-	-	-		32.5	-
	IDA										22.0	15.0	25.0	35.0	25.0		54.6	122.0
	Total										22.0	15.0	25.0	35.0	25.0		87.1	122.0
	No.										3	1	3	3	3		9	14
Lending Program	IBRD	41.5					2.8	-	32.5	-			-	-	-	2.8	32.5	-
	IDA	-					2.0	.6	17.0	-	30.0		15.0	15.0	15.0	2.0	47.6	75.0
	Total	41.5					4.8	.6	49.5	-	30.0		15.0	15.0	15.0	4.8	80.1	75.0
	No.	3					2	1	4	-	3		2	2	2	5	8	9
IBRD o/s inc. undisbursed		34.7	33.7	32.2	30.8	28.6	29.9	28.4	59.2	57.3	55.3	53.2	50.6	47.7	44.4			
exc. undisbursed		23.4	26.2	27.6	28.3	28.3	27.1	26.2	25.9	25.7	27.3	30.8	39.8	45.4	44.4			
IBRD - gross disbursements			3.8	2.3	2.1	1.3	.2	.7	1.4	1.7	3.6	5.6	11.5	8.5	2.3			
- net disbursements			2.9	.9	.7	- .1	-1.2	- .8	- .3	- .2	1.6	3.4	9.0	5.6	-1.0			
- net transfer			1.3	-1.0	-1.5	-2.0	-3.0	-2.2	-1.8	-1.9	.1	1.4	6.6	2.3	-4.7			
IBRD/IDA - gross disbursements			3.8	2.3	2.1	1.3	.2	.7	1.8	3.2	6.7	13.4	27.6	30.1	21.9			
- net disbursements			2.9	.9	.7	- .1	-1.2	- .8	.1	1.3	4.7	11.3	25.1	27.2	18.6			
- net transfer			1.3	-1.0	-1.5	-2.0	-3.0	-2.2	-1.4	- .7	3.2	9.1	22.5	23.6	14.3			

1/ If at all possible, should be moved ahead.
2/ Loan amount is $8.0 million. DFCC has advised, however, that not more than $1.0 million is likely to be required. $7.0 million is expected to be cancelled shortly.
3/ Jointly with other lenders.
* Net of cancellations.

South Asia Department
March 11, 1971

C E Y L O N

Attachment 2

INDICATORS OF DEVELOPMENT

I. ECONOMIC & STRUCTURAL INDICATORS	Unit	Annual Average 1961-1965	1966-1969	1970-1975 d/	
1. GDP (in constant prices)	% Change	3.6%	5.7%	4.8%	
2. Manufacturing Output	% Change	5.2%	6.8%	5.3%	
3. Agricultural Output	% Change	2.6%	4.6%	4.6%	
4. Imports of Goods and NFS	% Change	-1.4%	8.4%	0.0%	
5. Exports of Goods and NFS	% Change	0.8%	0.7%	0.0%	
6. Domestic Price Level	% Change	1.7%	3.8%	2%	
		1960	1965	1969	1975
7. Gross National Savings	% GDP	11.4%	12.1%	13.2%	12.8%
8. Resource Gap	% GDP	3.0%	-0.4%	5.9%	1.7%
9. Net Factor Payments Abroad	% GDP	0.3%	0.5%	0.0%	0.9%
10. Gross Domestic Investment	% GDP	14.6%	12.5%	19.0%	15.4%
11. Debt Service	% Exports	-	2.0%	8.5%	
12. Central Govt. Current Revenue	% GDP	20.7%	24.3%	23.4%a/	
13. Central Govt. Current Surplus (Deficit)	% GDP	0.3%	1.0%	1.2%a/	
14. Public Exp. on Social Services	% GDP	7.1%	7.0%	6.5%a/	
15. Military Expenditure	% GDP	0.9%	0.8%	0.7%a/	
16. Manufacturing Output b/	% GDP	11.2%	12.2%	11.7%	12.0%
17. Energy Consumption	MW	1965:89; 1970:175 c/; 1974:274 c/			
18. Fertilizer Consumption	'000 tons	1965:388.8; 1968:470			

II. SOCIAL INDICATORS		1950	1960	1965	1969
19. Population Growth Rate	%	3.2%	2.7%	2.5%	2.5%c/
20. Urban Population Growth Rate	%	2.6% (Average 1960-1966)c/			
21. Birth Rate	Per 1,000 popln.	40.4	36.0	33.2	31.7a/
22. Family Planning	Acceptors '000s.	1968:64; 1969:60			
23. Income of: Highest quintile	% total income	1963:50.3%; 1969:45.2%			
24. : Lowest quintile	% total income	1963:10.7%; 1969:9.4%			
25. School enrollment: Primary & Secondary	% school-age popln.	68.0%	80.0%		
26. Literacy rate	% adult population	63.0%			
27. Unemployment rate	% labor force	1968:10.7%			
28. Population per hospital bed	Number				

a/ Provisional.
b/ As percent of GDP at Current Factor Cost Prices.
c/ Estimate.
d/ Estimates represent targets which might be achieved within the assumed constraints of no growth of exports and imports.

South Asia Department
March 12, 1971

South Asia Department
October 14, 1971

CEYLON'S MEDIUM-TERM PLAN: 1972 - 1976

1. Ceylon's economic difficulties, due in large part to falling world prices for the country's major exports, have been greatly magnified by policies which have consistently subsidized consumption - including in particular the consumption of imported goods, such as rice - at the expense of investment. The economy has grown at an average rate of well below 4 percent since 1950; income per head of Ceylon's growing population has risen by about 1 percent annually. More than 13 percent of the total labor force, and about 40 percent of those in the age group 15-24, are estimated to be openly unemployed. This is the long-term background to the draft five-year plan and to the budget proposals for 1972 also being considered now.

2. The Plan emphasizes that there is no hope of preventing unemployment from rising further unless economic growth is sharply accelerated. It argues that for this reason the growth target should be not less than 5.8 percent, which is ambitious in relation to past achievements. "If the backlog of unemployment is to be prevented from increasing during the Plan period - and at around 13 percent of the labor force today, this had demonstrably created acute socio-economic tensions - it is vital that every effort be made to ensure the achievement of the 5.8 percent rate of economic growth." 1/ Without question, achievement of this objective will require a tremendous effort on the part of the country as a whole and major adjustments of Government policy.

3. This effort finds its most direct expression in the Plan's assessment that as "a conservative minimum estimate of the task that requires to be completed during the plan period" Rs. 14 billion must be invested - 55 percent more than during the preceding five years. Investment on the scale required will clearly be impossible of achievement unless the distribution of Ceylon's income between consumption and investment is changed substantially. Such re-distribution must be achieved essentially through the Government budget and the import budget, and the basis must be laid in 1972.

4. In proceeding to tackle a task of this magnitude, it appears essential that those responsible for the conduct of Ceylon's affairs should clearly recognize the major implications of the proposed Plan:

> First, some adjustments in policy are being forced on the Government in any event because the recent accumulation of short-term foreign credit cannot continue, and because the cost of the insurgency must be paid for. These measures will be required merely to bring Ceylon's total expenditures more nearly into line with its income and, if taken in such a way as to protect investment, would simply prevent a further deterioration, but would not by themselves bring about the redistribution of outlays necessary for achievement of the Plan's objectives.

1/ All quotations are from the Plan documents.

Second, there is an essential difference between the effect of measures taken to bring total outlays of the economy into line with its income, while protecting investment, and those called for to support an employment-oriented development program. The former involve a real sacrifice. In contrast, the latter is tantamount to a re-distribution of expenditure and income in favor of those presently unemployed. Thus, the latter measures should, by and large, leave the welfare of families having unemployed members unchanged. At the same time, society as a whole should be better off, because any employment-oriented development program, if well directed, should lead to increases in total production.

Third, to be visibly effective in providing additional employment and in stimulating production, the amount shifted from consumption to investment must be large; a marginal shift is not likely to provide the impetus necessary. According to the Plan, the shift in the budget should be no less than Rs. 500 million in 1972, and this must be supported by curtailing imports of consumer goods.

Fourth, in adopting the approach put forward in the Plan, the Government assumes a very large responsibility. For it must ensure that the money "taken away" from current consumption is spent effectively on improving the conditions of the unemployed and of the economy as a whole.

To elaborate:

5. The Plan "involves a domestic savings effort that is rather larger than the country has shown itself capable of in the past". The Plan proposes - and this view is shared by the Bank staff - that the additional savings should be raised through the Budget by means of new taxation or reduced current expenditures. Considering Ceylon's present high tax rate, reductions in current expenditures will presumably have to provide the bulk of this increase in savings. Additional borrowing would merely shift resources from private to the public sector, and would not contribute to financing the needed increase in total investment. The Plan has calculated that, in order for the Plan to stand a chance of being successful, the 1972 budget must generate an addition of Rs. 500 million to the current surplus. In other words, it must provide for new taxation (not including the normal increase of revenues from existing taxes) and reductions in current expenditures below their normal growth, totalling at least Rs. 500 million in 1972.

6. To secure the external resources needed for intermediate and capital goods imports, imports of food and other consumer goods must be reduced by 40 percent below their 1970 levels, and export earnings would have to grow by about 3.8 percent annually, in sharp contrast with their steady decline throughout the 1960's. In the face of an expected continued decline in the prices of Ceylon's major exports, dramatically imaginative and successful new policies would be required to achieve this target. The Plan does not indicate what those policies might be. In fact, while a major effort must clearly be made, it is difficult to be optimistic about full success

on this front; as the Plan itself sees it, additional recourse to aid will probably be needed to offset the likely shortfall of export earnings from their target. This makes it all the more important rapidly to reduce consumption imports at least by the 40 percent Plan target rate. There is clearly a need for specific measures to stimulate exports and import-substitution; but most of the burden of securing the external resources needed also falls on measures designed to compress consumption; ultimately, on the achievement of a real budget surplus, as discussed in paragraph 5.

7. Generation of sufficient external and internal resources is a necessary, but not a sufficient condition of development. The resources must also be put to good use. The sectoral volumes of the Plan do not spell out the investment strategy intended to be followed. However, the Government has requested the ILO to organize a study and make recommendations for improving the employment situation. The ILO mission, headed by Prof. Dudley Seers, have now submitted their recommendations to the Government. These amount to a comprehensive strategy geared to reducing unemployment as fast as practicable. They take full account of the work of the Planning Ministry, and of Government priorities in general, and fit well within the overall framework of the Plan. Presumably, the Government will wish to take these recommendations carefully into account in evolving the comprehensive and consistent development strategy it so urgently needs.

South Asia Department

October 14, 1971

CEYLON

CAPITAL REPAYMENTS AND INTEREST PAYMENTS, 1971-72
(In US $ million)

		1971	1972
Capital			
IMF		23.4	37.0
Official Loans		15.9	19.0
Of which Bank/IDA		(1.9)	(2.3)
Supplier's Credit		11.4	12.1
Bank Borrowings		16.1	10.1
Short-Term Credits		45.9	65.5
	Total	112.7	143.7
Interest			
Official Loans		8.5	9.5
Of which Bank/IDA		(1.6)	(2.4)
Supplier's Credit		2.9	3.5
Bank Borrowings		4.4	3.4
Short-Term Credits		4.6	6.5
	Total	20.4	22.9
	GRAND TOTAL	133.1	166.6
	EXPORTS	350	351
	% OF EXPORTS	38	47

South Asia Department

October 14, 1971

STATEMENT OF BANK LOANS
As of September 30, 1971
U.S. $ Million

CEYLON

South Asia Department Div. D

Loan No.	Date of Loan Agreement	Project Name	AMOUNT Original	Principal less Cancellations	Closing Date	Undisbursed Balance	Outstanding Disbursed Amt. (less Amount sold and repaid)	Remarks
101	July 9, 1954	Power Aberdeen-Laksapana Hydro	19.1	15.9	Dec. 31, 1960	--	7.8	Maturities 1959-79 Interest Rate 4 3/4% P. A.
209	Sep. 17, 1958	Power Grandpass Thermal	7.4	7.3	June 30, 1967	--	3.8	Maturities 1961-78 Interest Rate 5 3/8% P. A.
283	June 6, 1961	Norton Bridge Hydro & Second Grand Pass Thermal	15.0	14.1	Dec. 31, 1966	--	10.6	Maturities 1964-86 Interest Rate 5 3/8% P. A.
520	Nov. 22, 1967	D. F. C. C.	4.0	2.3	June 30, 1972	0.1	2.1	Maturities 1970-85 Interest Rate. Not fixed at the time of loan agreement.
569	Nov. 12, 1968	Highway	4.9	--	--	--	--	Loan cancelled Feb. 16, 1971.
634	July 18, 1969	Second D. F. C.C.	8.0	3.0	Dec. 31, 1973	2.6	0.4	Maturities 1972 - 87 Interest Rate 6 1/2% P. A.
636	July 28, 1969	Power Maskeliya Oya II	21.0	17.0	Sept. 30, 1973	15.2	1.8	Mt. 1974-94 Int. 6½% P.A.
653	Jan. 30, 1970	Mahaweli Ganga	14.5	14.5	June 30, 1976	14.4	0.1	Mat. 1976-2000 Int. 7% P.A.
		TOTAL	93.9	74.1		32.3	26.6	

South Asia Department

October 14, 1971

STATEMENT OF IDA CREDITS
As of September 30, 1971
U. S. $ Million

CEYLON

South Asia Department Div. D

Credit	Date of Credit Agreement	Project Name	Amount Original	Principal Less Cancellations	Closing Date	Undisbursed Amount	Outstanding Disbursed Amount	Maturities
121	June 19, 1968	Lift Irrigation	2.0	2.0	June 30, 1973	1. 2	0. 8	1978-2018
133	Nov. 12, 1968	Highway	4.9	0.6	June 30, 1973	0.05	0.6	1979-2018
168	Nov. 13, 1969	Land Reclamation & Drainage	2.5	2.5	June 30, 1976	2.0	0.5	1979-2019
174	Jan. 30, 1970	Mahaweli Ganga	14.5	14.5	June 30, 1976	12. 2	2. 3	1980-2019
		TOTAL	23.9	19.6		15.5	4.2	

6

7

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

CONFIDENTIAL

TO: Records

DATE: February 14, 1972

FROM: J.-D. Roulet

SUBJECT: Ceylon: Mr. McNamara's meeting with Dr. N.M. Perera, Finance Minister

1. On January 22, 1972, Mr. McNamara met in Colombo with Dr. N. M. Perera, Minister of Finance and Governor for the Bank. Also present on the Ceylonese side was Mr. C. Coorey, Finance Secretary, and for the Bank Messrs. Cargill, Clark, Blobel, Ljungh and myself.

2. In reply to Dr. Perera's welcoming remarks, Mr. McNamara said how pleased he was for this opportunity to visit Ceylon, and he hoped that, despite the short time available, he would be able to get a greater understanding of Ceylon's problems.

3. Dr. Perera said that his major concern at the present time was the gap created in the 1971/72 budget by the withdrawal by Government, in the face of Parliamentary opposition, of some of the fiscal measures he had originally proposed. He explained that starting with a basic level of revenues of the order of Rs. 2,700 million, his original budgetary proposals included measures expected to bring about some Rs. 400 million additional revenues. This incremental amount, he recognized, was still below the target of Rs. 500 million considered in the recent Five-Year Plan as the minimum required to meet the country's development and social needs. Yet these measures had met with such opposition in Parliament that the Government had felt they had to withdraw some of them. The consequence would be a reduction of the order of Rs. 240 million in the expected incremental revenues.

4. Dr. Perera expected that the Prime Minister would wish to describe in greater detail to Mr. McNamara the political constraints that had led to this decision. In brief, the country had hardly recovered from last year's insurgency and back benchers were convinced that unless fiscal measures placing an additional burden on the masses were accompanied by other measures demonstrating the Government's intention to carry out social reforms, renewed unrest would be inevitable. The Government was now hoping that a more favorable climate would be created after the submission to Parliament of its proposed land reform program. This program which would include a ceiling on private land holdings -- with the exception of rubber and tea estates -- was not expected to have substantial economic consequences, but its political impact was considered

President has seen

fundamental. Dr. Perera said that this bill was expected to be introduced early in February, whereupon he thought that members of Parliament would then accept his proposals for fiscal improvements since they would then be in a position to face their electorates with a more balanced set of measures.

5. Mr. McNamara said that in his opinion the need to raise additional revenues was so obvious that it was hardly possible to understand why the original budgetary proposals had met with such fierce opposition, and he wondered if members of Parliament really understood the nature and gravity of the problem. Unless additional revenues could be raised, it would be impossible for the Government to meet what appeared to be minimum investment targets and he was therefore puzzled by the fact that the very measures expected to bring about economic improvement and designed by a Government so dedicated to the welfare of its people had to be withdrawn. Dr. Perera felt that many Parliamentarians now understood the problem. Indeed he thought that in several instances the electorate might have had a greater understanding of what was required and that to some extent members of Parliament were actually lagging behind the people. Yet he felt that the population was expecting the fulfillment of promises made during the election campaign, many of which he recognized the country could not afford.

6. In any event Dr. Perera admitted that the fiscal gap had to be bridged as soon as possible. Indeed, time was of the essence since more than four months of the budgetary period of 15 months had already elapsed. In reply to a question by Mr. McNamara, Dr. Perera said that the measures he intended to introduce would probably include the introduction of a price of 25 cents for the first measure of rice so far given free, an increase of 5 cents in the price of flour and reduction to 2 lbs. in the sugar ration. Dr. Perera admitted that these measures were not unlike those included in his original budget but he felt confident that this time Parliament would go along. Dr. Perera added that in the meantime he was attempting to reduce expenditures and in any case to resist pressure for increases in expenditures. He indicated that on certain fronts these pressures were considerable, particularly for wage increases, but so far the Government had been successful in containing them.

7. Dr. Perera said that another important problem facing Ceylon was the need to reschedule its external debt, a substantial part of which consisted of short-term credits incurred in large part by the previous Government. In reply to a question, Dr. Perera estimated Ceylon's total short-term debt at about $100 million. Unless some rescheduling could be

arranged, Ceylon would find itself unable to finance essential industrial inputs. In reply to a question by Mr. McNamara, Dr. Perera said that non-essential imports had already been drastically cut and that the total level of imports, currently of the order of $375 million, was much below the level required to enable the economy to grow at the rate contemplated in the Five-Year Plan. By way of comparison, the level of imports in 1968 had been of the order of $430 million and $450 million in 1969.

8. Mr. McNamara enquired about the level of food imports. Dr. Perera replied that for the coming year rice imports were expected to reach about 300,000 tons, while the import of wheat flour was anticipated to range between 300-350,000 tons. Prospects for increased local production of food were considered hopeful, particularly for rice where self-sufficiency was expected to be reached by 1974. The Government expected to achieve this through its subsidy program for fertilizer, the attractiveness of the floor price of Rs. 14 per bushel, and great hopes were placed on the use of new strains developed locally. Yet it was recognized that to reach self-sufficiency would mean an increase in rice production of the order of 20%, and that the results of last year when production had actually declined by about 17% compared to the previous year, had been very disappointing. Rice production this year was expected to remain at about last year's level. Regarding wheat, Dr. Perera pointed out that there was no local production and imports seemed to have now stabilized at about 300,000 tons annually. He pointed out that when the previous Government had cut the rice measure, there had been a substantial switch in demand from rice to wheat, of the order of about 100,000 tons. It was therefore hoped that with the increase in rice production, wheat imports could to some extent be reduced, although this was questionable since the habit of consuming wheat seemed by now to have taken root.

9. With respect to sugar, Dr. Perera said that practically all requirements had to be imported. Ceylon had only two refineries and local production hardly reached 50,000 tons compared to total consumption of about 250,000 tons. It was pointed out that the disappointing performance in sugar production had to be attributed to a variety of circumstances, including poor management. Good results had, on the other hand, been achieved with the production of onions and chillies. The import of onions had already been banned and Government had recently decided to ban the import of chillies as well. The ban was expected to be made operative after the New Year.

10. Turning to Ceylon's export prospects, Dr. Perera said that the outlook for tea was now somewhat better, but that on the other hand the prospects for rubber were less favorable. The replanting programs were proceeding, but progress was slow. In reply to Mr. McNamara's comment that Ceylon's tea exports had been lagging and that actually Ceylon had

failed to reach its export quota, Dr. Perera pointed out that the volume of exports was now actually lower than five years ago, which he attributed to the fact that the tea estates had not been properly maintained. The Government was therefore in the process of intervening to remedy this situation. He did not think that the decline in production was due to the high level of taxation, although he recognized that the current level, amounting to about 90% of gross surplus, was high. On other fronts, Dr. Perera pointed out that the growth of tourism had been considerable, particularly during the last two months when about 10,000 tourists had visited Ceylon, but he agreed that in the short run tourism would remain a small factor. Bunkering operations had turned out to be more profitable than expected. He thought that gem exports were promising and might bring in about Rs. 100 million.

11. Mr. McNamara enquired about the level of public and private savings. Dr. Perera referred to the success of the compulsory savings scheme that had been put into effect last year and to the ceiling on income that had recently been introduced. He recognized that this latter measure was unlikely to bring about a substantial amount but its political significance was very important. Dr. Perera also referred to the increase in interest rates on Government bonds to 9% and on postal savings to 7.2% decided last year, to the creation of a national savings bank and the efforts to set up rural branches so as to tap rural savings. This, however, he recognized would be a slow process.

12. Mr. McNamara enquired about the current level of unemployment which Dr. Perera estimated at about 600,000 including the backlog. In this connection, Dr. Perera stressed that the Five-Year Plan provided for an investment program totalling Rs. 15 billion, of which Rs. 7 billion were expected to come from the public sector. This year's budget had provided for investments in the order of Rs. 800 million but it was questionable that resources would be found to that extent. Questions were also raised about the private sector providing its share of the investment program, given current attitudes towards private industry. Dr. Perera agreed that the private sector was less happy now than it previously was.

13. With reference to the new Five-Year Plan, Mr. McNamara enquired about the status of Seers' report which addressed itself specifically to the problem of unemployment and had outlined a variety of proposals to bring about improvements. Dr. Perera said that the report was currently being studied in Ceylon and merely commented that while some measures such as land reform were expected to be implemented, others might not prove feasible.

14. Turning finally to the Aid Group, Mr. McNamara emphasized that the Aid Group members were expecting advice from the Bank. The basic question was what we now could tell them. He felt certain that Aid Group members would be prepared to continue supporting Ceylon, but that they would want to satisfy themselves that there was some measure of economic development. He was therefore concerned that with practically all resources being spent on consumption and little being left for investment, it would hardly be possible to muster support from Aid Group members. It was in this context that the withdrawal of the revenue measures had come as a shock not only to the Bank but also to other Aid Group members. Action on the revenue front was essential and Mr. McNamara said that he had felt encouraged by Dr. Perera's assurances that this would be done soon.

JDRoulet:dp/myc

cc: Messrs. McNamara, Knapp, Cargill, Votaw, Melmoth, Blobel, Baneth, Cleveland.

8

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

CONFIDENTIAL

TO: Records

DATE: February 15, 1972

FROM: J.-D. Roulet

SUBJECT: Ceylon: Mr. McNamara's meeting with Dr. H. A. de S. Gunasekera, Secretary, Ministry of Planning and Employment

1. On ~~October~~ January 22, 1972, Mr. McNamara met in Ceylon with Dr. H. A. de S. Gunasekera, Secretary, Ministry of Planning and Employment. Also present were Mr. Godfrey Gunatillake, Director, Plan Implementation Division, Ministry of Planning and Employment, on the Ceylonese side and for the Bank Messrs. Cargill, Clark, Blobel, Ljungh and myself.

2. Dr. Gunasekera who, as Secretary to the Ministry of Planning and Employment, was the person responsible for the preparation of the recent Five-Year Plan, began by giving an outline of the major features of the Plan. He added that one of the major questions now was how resources could be found to meet the Plan targets. As everyone knew, the Government had in its last Budget made a number of proposals but in the face of strong opposition from backbenchers in Parliament, had been compelled to withdraw several of them. In reply to a comment by Mr. McNamara that he was puzzled that a Government dedicated to improving the condition of its people had been forced to withdraw the very measures designed to bring about development, Dr. Gunasekera said that in his opinion this showed a lack of understanding of Ceylon's economic problems by politicians. Members of Parliament, he said, believed that they could not allow any cuts in the current standard of living of Ceylon's population and expected to solve the resources problem by getting sacrifices from those only who, in their view, could afford them even though it was obvious that even if all "haves" were to make sacrifices, this would still be far from sufficient. The privileges of the few were politically unacceptable and there was therefore a need for compromises by combining measures requiring sacrifices from the masses with other measures demonstrating the Government's determined intention to carry out its electoral promises. As examples of these, Dr. Gunasekera mentioned action on nationalization as well as the introduction of the land reform program that would include a ceiling on land ownership. Dr. Gunasekera felt, however, that the need for early action on the fiscal side was now recognized and he was hopeful that this would be done shortly.

3. Dr. Gunasekera thought, however, that if the need for revenue-producing measures was recognized, time would still be needed to get general support for the Plan. In this respect, Mr. McNamara pointed out that mobilization of the resources required to implement the Plan would seem to

require a change in Ceylon's consumption/production pattern of the order of 5-10%. This would undoubtedly be a difficult adaptation to make. Dr. Gunasekera thought that this could be achieved in about two years. In reply to a question by Mr. McNamara regarding areas in which the Government expected to achieve a reduction in consumption, Dr. Gunasekera said that the major effort would have to be directed at the rice ration. Calculations had been made that should the first measure of 2 lbs. be sold at a price of 25 cents instead of being given free, this would produce a relief of about Rs. 150 million for the budget. On the other hand, he felt that a reduction in wheat consumption might be very difficult to bring about since the population had now become used to eating bread.

4. Turning to the question of savings. Dr. Gunasekera stated that to meet the requirements of the Plan, total savings would have to rise from a current level of 12.5% of GDP to 17% of GDP. This, he recognized, was a considerable increase when compared to past performance. On the Government's side, a substantial amount (over Rs. 1100 million over the total Plan period) was expected to come from surpluses on current accounts, and over Rs. 900 million from contributions by public corporations. Programs were being devised to increase the productivity of these corporations. These included improvement in management. Part of the increase was expected to be achieved by expanding output, but in this respect the availability of raw materials was a serious constraint. Compared to 1968/69, the allocation of raw materials had been cut by about 40% the last year.

5. Dr. Gunasekera recognized that a substantial part of the investments contemplated in the Plan would have to be financed with private savings, and in this respect he referred to the creation of the National Savings Bank and to the Government's plan to launch a savings drive in rural areas. Investments in housing represented a substantial part of total investments and the Government was currently considering measures to stimulate housing construction. These would include the creation of a national building corporation as well as the development of plans for low cost housing and the adoption of policies for hire-purchase of houses.

6. Mr. McNamara then broached the question of the balance of payments. Dr. Gunasekera stated that an important problem was that of refunding Ceylon's short-term debt. Last year the Government had some success in extending the repayment period for some of its debt. No further talks with creditors had been held. Mr. McNamara observed that, generally speaking, creditors' willingness to consider rescheduling was contingent on there being a comprehensive program for improving the balance of payments position into which debt rescheduling would fit as a means of providing relief.

7. Dr. Gunasekera pointed out that the Government expected to reduce its food import bill by making vigorous efforts to increase local production, mainly for paddy. This would require more intensive cultivation, the opening

up of new land, the use of new strains as well as improvements in extension services (in this respect he pointed out that the ratio of extension officers to population was 1:5,000 in general as against 1:500 in colonization schemes). Progress would also be accelerated by irrigating new lands in Ceylon's dry zone. In this respect Dr. Gunasekera pointed out that the Five-Year Plan contemplated the opening up of 200,000 acres. This included the second stage of the Mahaweli Project, the justification of which had been questioned by some experts including Bank staff members. He personally did not share these doubts and stressed the need for proceeding with the project as planned in 1974.

8. Turning to foreign assistance, Dr. Gunasekera explained that Ceylon was hoping to receive about Rs. 600 million (about $100 million equivalent) from all sources in 1972, of which Rs. 450 million for commodity and Rs. 150 million for project aid. It was pointed out that commodity assistance had in the past been provided exclusively by Aid Group members and that given past trends, the amount of Rs. 450 million was on the high side. With respect to the Aid Group, Mr. McNamara pointed out that at the previous meeting, members had stressed the need for the Government to take action to put the economy back on the path of development, and said that Ceylon's actual performance had come as a great disappointment. Indeed the recent setback suffered by the Government in Parliament had come to many as a shock. In reply to a question, Dr. Gunasekera said that Ceylon had not approached China for a loan similar to that made last year and felt doubtful that China would be prepared to repeat this action. In general terms, Dr. Gunasekera noted out that certain groups in Ceylon were hoping that assistance from China and other Eastern countries would replace assistance from the West, but Eastern assistance so far had remained very limited.

JDRoulet:dp/myc

cc: Messrs. McNamara, Knapp, Cargill, Votaw, Melmoth, Blobel, Baneth, Cleveland.

9

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

CONFIDENTIAL

TO: Records

DATE: February 15, 1972

FROM: J.-D. Roulet

SUBJECT: Ceylon: Mr. McNamara's meeting with Mr. Maithripala Senanayake, Deputy Prime Minister and Minister of Irrigation, Power and Highways

1. On January 22, 1972, Mr. McNamara met in Ceylon with Mr. Maithripala Senanayake, Deputy Prime Minister and Minister of Irrigation, Power and Highways. Also present for the Bank were Messrs. Cargill, Clark, Blobel, Ljungh and myself.

2. In reply to Minister Senanayake's words of welcome, Mr. McNamara said how pleased he was for this opportunity to visit Colombo, and that he hoped that despite the limited time available, he would be able to broaden his understanding of Ceylon's difficulties. Referring to the recent setback suffered by Government at the hand of Parliament on the budget proposals for 1971/72, he asked Minister Senanayake how one could explain that a Government so dedicated to improving the condition of its people had been forced to withdraw some of the very measures aimed at bringing about economic development in the country. Minister Senanayake candidly admitted that the answer was to be found in Ceylon and that politicians were probably partly responsible. Over the years, he said, Ceylon had become used to various welfare measures and there was in the country a considerable resistance against reducing any of them, although it was obvious that the country could not afford them all.

3. During the last election campaign, promises had been made on the strength of which many new members of Parliament - about one-third in the Coalition's main party - had been elected. People now expected these promises to be fulfilled and unless they could see that progress was being made, discontent would continue to increase. Minister Senanayake felt that the key to the solution was to go directly to the people. If practical steps could be introduced that could be appreciated directly by the people, they would, he felt, go along with other measures requiring sacrifices. Fiscal measures, for example, would, in his opinion, be acceptable but only together with other measures such as the proposed land reform program. To permit closer contact with the population, he had within his own Ministry undertaken a reorganization program to ensure that actual needs were being taken into account in the planning and carrying out of civil works. A basic feature of this program was the creation of engineering units to go directly to villages and ascertain what the people wanted to be done. The insurrection of last April had, of course, slowed down this reorganization, but good progress was now being made.

4. Another problem besetting Ceylon was, in Minister Senanayake's opinion, that while export earnings had gone down, the cost of imports had increased. This had resulted in price increases in import commodities which, together with shortages, had contributed to general dissatisfaction. In Minister Senanayake's opinion, vigorous efforts were needed to increase local production in substitution for imports. This also would require far-reaching reorganization and complementary works such as, for example, the construction of roads to ensure that the farmers' products could be brought to the markets. Minister Senanayake added that in order to keep prices down, the Government was planning to assume the distribution function, particularly with respect to paddy, thereby by-passing the middle man, and he described the Government's plans to improve the organization of the cooperatives. In reply to a comment by Mr. McNamara that Ceylon, a country with a very favourable climate, was forced to import about 40% of its food requirements, Minister Senanayake recognized that consumption of certain items would have to be reduced. The items he particularly had in mind were sugar (in this connection he noted that the recent increase in the ration from 2 to 3 lbs. following Parliamentary opposition to the budgetary measures, had accomplished nothing since the third pound was generally sold back on the black market), potatoes, the import of which had been banned by Government, and textiles for which he thought the creation of a national board might be desirable. In addition, Minister Senanayake recognized that exports would have to be increased and in this connection mentioned the recent White Paper on investments issued by Government as well as plans to create a free industrial zone in Trincomalee.

5. Turning to the unemployment problem, Minister Senanayake expressed the view that inadequate employment policies had created much frustration. In his opinion a reorganization effort was required to allow people to have their say in how jobs should be allocated.

6. Another field in which Minister Senanayake thought decentralization should be introduced was that of budget preparation. In his opinion while the Government should keep responsibility for making sectoral and geographical allocations, actual appropriations within these limits could be determined locally. Thus, for example, for civil works villagers could decide, within a given amount, if they wanted roads or irrigation works etc. Such a formula, he thought, would be very popular and could enable Government to rally support from many backbenchers.

7. Mr. McNamara stressed that the Bank and the Aid Group were willing to help Ceylon, but that there was a need for evidence of economic development. In this context the events of November had come as a shock. Minister Senanayake related these to the April insurgency and to the fear of backbenchers, some of whom had not yet dared to return to their constituencies, that an additional burden placed on the masses would create new unrest.

JDRoulet:dp

cc: Messrs. McNamara, Knapp, Cargill, Votaw, Melmoth,
Blobel, Baneth, Cleveland

10

OFFICE MEMORANDUM

TO: Records

DATE: February 25, 1972

FROM: J-D. Roulet

SUBJECT: CEYLON - Mr. McNamara's Meeting with Mr. Hart Schaaf, United Nations Resident Representative

1. On January 23, 1972 Mr. McNamara met briefly with Mr. Hart Schaaf, UNDP Resident Representative for Ceylon. Also in attendance for the Bank were Mr. Cargill and Mr. Blobel.

2. Mr. Schaaf outlined the general situation in Ceylon as he saw it. In his opinion the Government now realized the seriousness of the foreign exchange position. In addition the insurgency of last April had come as a real shock. For these reasons he had thought for a while that the Government would be receptive to advice as to what to do to bring the economy back on the road to development but citing the delays in announcing the Five Year Plan and the subsequent Government defeat on its budgetary proposals he was now much less optimistic.

3. Turning to Ceylon's technical assistance needs, he said that the UNDP had recently prepared a Five Year Program totaling about$15 million but had so far received little active support by Government in attempting to identify critical areas where UNDP assistance might be most useful. Included in the program were three projects (rice milling, Colombo town planning and skip-jack fishing) and he hoped that the Bank could act as executing agency for anyone or preferably all of them. Mr. McNamara undertook to have him apprised of the Bank's decision within about a week.*

cc: Messrs. McNamara, Cargill/Votaw, Melmoth, Blobel/Baneth, Cleveland & Riley

* This was done by cable and letter on January 26, stating that the rice milling and town planning projects had already been approved with FAO and the United Nations, respectively, appointed as executing agencies, and the request for the skip-jack fishing project proposed to retain FAO as executing agency. By letter of February 3, Mr. Schaaf asked the Bank to consider replacing FAO in that function. The matter was reconsidered but in view of the arrangements whereby the Bank usually does not carry out feasibility studies and in this case in particular of FAO's expertise in this field, there would be no advantages in making such a change. A letter is being prepared informing Mr. Schaaf.

11

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: FILES

DATE: February 8, 1972

FROM: Manfred G. Blobel

CONFIDENTIAL

SUBJECT: CEYLON: Mr. McNamara's Meeting with the Prime Minister

1. On January 23, 1972, Mr. McNamara met with the Prime Minister of Ceylon, Mrs. Sirimavo Bandaranaike. Also present were, on the Ceylonese side, Mr. H.A. de S. Gunasekera and Mr. Godfrey Goonetilleke and, for the Bank, Mr. Cargill and myself.

2. Mr. McNamara said that in his meetings with Ministers and officials the previous day he had gained much greater understanding of the economic difficulties besetting Ceylon and he was deeply perturbed. It seemed that the shortage of foreign exchange was forcing Ceylon to live with imports totally inadequate to sustain economic activity at a reasonable level and to meet the needs of development. Savings were very low and, unless it was possible to raise them substantially, the amount of resources available for investment would fall far short of the Government's targets which he understood to be the minimum required for meeting the country's social and economic problems. It was in this context that he was greatly shocked when he learned in early November that opposition in Parliament had forced the Government to withdraw a substantial part of the fiscal measures it had proposed in the budget for 1971/72. He was puzzled why the Prime Minister's Government, which was obviously dedicated to the welfare of the people, should have run into such difficulties in obtaining support for its proposals.

3. The PM said that she recognized the urgent need for action on the fiscal front, but explained that the insurgency that broke out last April had dissuaded her from taking a firm stand. She noted that some insurgent activity was continuing in the North Central Province. She emphasized that the Government had been able in April to deal with the insurgency as expeditiously as it did only because it had the overwhelming support of the people. Strong fiscal measures designed to curtail mass consumption in her mind held the danger of alienating the masses and driving them into the arms of the insurgents.

4. Mr. McNamara remarked that what the PM had just said in his view summed up the dilemma the Government was facing. While prompt action on the fiscal front might lose the government support now, failure to act would undoubtedly sharply aggravate an already very difficult situation and thus mean courting disaster in the very near future.

5. The PM explained that in her view a demonstration by the Government of its earnestness about social reform would create a climate in which the public would be prepared to accept fiscal action. The Government had therefore decided to proceed with legislation imposing a ceiling on individual holdings of agricultural lands except in respect of tea and rubber plantations. She expected that such a Bill

President has seen

could be introduced in Parliament in early February and was confident that soon thereafter the Government would be able to submit its proposal for fiscal improvement. However, she hoped that the outside world would show understanding of the difficulties which the Government faced in attempting, in a democratic framework, to take measures that would curtail mass consumption.

6. Mr. McNamara assured the PM that these difficulties were well understood and it was for the purpose of finding out how the Bank, as a lender for development, and as a Chairman of the Aid Group could help Ceylon cope with its difficult problems, that he had come to visit Ceylon. However, he also had to point out that the Bank was concerned with development and, therefore, would find it difficult to help where the prospect was that its assistance would merely put off an acute economic crisis for a little while, rather than support development. Bilateral lenders, who were members of the Aid Group, faced similar constraints. He appealed to the PM to use her proven qualities of leadership in an effort to gain popular support for the kind of action required to put Ceylon back on the course of development and thereby to provide the context in which the outside world could effectively help.

7. The PM drew attention to the heavy debt service obligations with which Ceylon had to cope over the next few years. These further complicated a very difficult situation. Ceylon needed some breathing space, and she enquired whether it might be possible to arrange for some relief.

8. Mr. McNamara replied that what he had said about aid also applied to debt relief. As far as he could judge, Ceylon's creditors would be very reluctant to agree to provide relief unless they were satisfied that by deferring service payments they were in fact making it easier for Ceylon to meet its obligations. At present and in the absence of action by the Government creditors would be inclined to fear that Ceylon's ability to service the debt would deteriorate rather than improve with the passage of time. However, if the Government provided the right context he was confident that creditors would be prepared to do what they could to help Ceylon.

cc: Messrs. McNamara
Knapp
Cargill
Votaw
Melmoth
Baneth
Roulet

MGBlobel:ad

12

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

CONFIDENTIAL

TO: Records

DATE: April 6, 1972

FROM: J.-D. Roulet

SUBJECT: CEYLON: Mr. McNamara's Meeting with Ambassador Kanakaratne

1. The Ambassador of Ceylon, Mr. Neville Kanakaratne, accompanied by Mr. Susantha de Alwis, First Secretary with the Embassy, met with Mr. McNamara yesterday. Mr. Cargill and I were present.

2. The Ambassador began by saying that although he realized that Mr. McNamara was fully aware of Ceylon's problems, particularly after his visit to Colombo last January, he wanted to stress again the constraints in which the Government was operating and which made it impossible politically to take all the steps that would be required to put the economy firmly back on the path to development. He described the various measures taken since the beginning of the year but unfortunately, he added, adverse events had also occurred that had largely offset their expected impact. The Prime Minister and the Government were fully aware that more needed to be done but politically, they had gone as far as was possible. At the time of Mr. McNamara's visit, the Prime Minister was hopeful that within a few weeks the long-awaited land reform program would be introduced to Parliament but the proposals turned out to be inadequate and required further work before they could be submitted to Parliament. Until this was done, the Government was convinced that to ask for more sacrifices from the poorer sections of the population would be unacceptable and entail a substantial risk of pushing them into the arms of the insurgency movement that had remained rampant. The Ambassador also pointed out that the Prime Minister was heading a coalition Government and that she had an extremely difficult task in keeping it together in view of frequent divergences of views among the various sections concerned.

3. The Ambassador stressed that the Prime Minister, who followed a pragmatic approach, hoped that the Bank and members of the Aid Group appreciated these difficulties and would be willing to participate in the forthcoming meeting of the Aid Group originally scheduled before the end of April. The Ambassador added that the Prime Minister had recently talked to the ambassadors of all Aid Group countries and that the response seemed favorable.

4. Mr. McNamara replied that the Bank fully appreciated Ceylon's difficulties and that one of the purposes of his visit had been to see how the Bank could help. Only the Government could judge what was politically acceptable or not. He added that the Bank was willing to convene a meeting of the Aid Group if Aid Group members were prepared to participate, but he wanted to make it quite clear that the Government

President has seen

was taking a risk insofar as a meeting convened now might not lead to increased offers of assistance. Informal conversations with members of the Aid Group had indicated that before deciding what to do, Aid Group members wanted to see the Economic Report. This report had just been revised in light of the conversations Mr. Baneth had in Ceylon a few days ago. It was now being printed and was expected to be distributed in a few days. We would then contact the members of the Aid Group to seek their reaction. Should the response be favorable, a meeting could probably be scheduled some time in the second half of May to give delegations enough time to study the report. Mr. McNamara said that he would encourage members to attend but, of course, could not guarantee what the response would be.

5. The Ambassador said he was pleased to hear Mr. McNamara's comments and added that the Government fully realized that the meeting might not be fully successful. Yet, the Government felt that the risk of an unsuccessful meeting was smaller than that which an indefinite postponement would entail. The Government was convinced of the need for external assistance but this view was not unchallenged and to cut ties with the Aid Group would strengthen the hands of the opposition.

6. It was agreed that we would keep the Ambassador informed of further developments.

J-DRoulet:myc

cc: Messrs. McNamara, Cargill, Votaw, Mendels/Hilken, Blobel, Cleveland.

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. McNamara

DATE: April 3, 1972

FROM: for I.P.M. Cargill

SUBJECT: Ceylon: Meeting with Ambassador Neville Kanakaratne

Wednesday, April 5, at 1230

1. The Ambassador of Ceylon, Mr. Neville Kanakaratne, has an appointment to see you ~~tonight at 5 p.m.~~ The main point he will want to raise concerns the Ceylon Aid Group that had originally been tentatively scheduled to meet at the end of April.

2. Little action has been taken by the Government since your visit last January. What has been done, in fiscal and import policy, would in any event have been far from sufficient to put the economy back on the path of development. As it turned out, prices of major imports have since increased considerably, and as a result of a continuing drought, a large increase in imports of rice will be required. Consequently, prospects are now somewhat worse than they were in January.

3. On the occasion of the Pakistan Consortium meeting about three weeks ago, I had informal discussions with members of the Ceylon Aid Group to ascertain their views about the desirability of having a meeting in present circumstances. The general response was that, before passing judgment on this, they would want to see the economic report. The report is now about to be printed in final form and should be distributed some time next week. Shortly thereafter, I intend to ask Aid Group members whether they want to have a meeting. If the major Aid Group members are prepared to participate, I suggest that we go along, ensuring, however, that the Government of Ceylon is fully aware of the risk it is taking in having a meeting that may not lead to fresh commitments of aid. In any event, the meeting could not be held before mid-May in order to give participants enough time to study the economic report.

cc: Mr. Cargill
Mr. Votaw
Mr. Cleveland

President has seen

BIOGRAPHICAL DATA

Mr. Neville Kanakaratne, Ceylon's Ambassador to the U.S.A., was educated at the University of Cambridge and is a Barrister-at-Law (Middle Temple, London). Born in 1923, he joined the Public Service in 1951 as Crown Counsel in the Department of the Attorney-General of Ceylon. In 1957-1961, he was the First Secretary and Legal Adviser to the Permanent Mission of Ceylon to the United Nations. In 1961, he joined the United Nations Secretariat on personal invitation of the late Secretary-General, Dag Hammarskjold, and served as Legal Adviser to the Secretary-General's Special Representatives in Congo, Gaza and Cyprus. In 1967, he became Minister (Economic Affairs) of Ceylon's High Commission in London where he remained until his appointment as Ambassador to the United States in August, 1970.

13

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Records

DATE: September 27, 1972

FROM: J.-D. Roulet

CONFIDENTIAL

SUBJECT: Sri Lanka: Meeting of Annual Meeting Delegation with Mr. McNamara

1. The delegation of Sri Lanka consisting of Dr. N.M. Perera, Minister of Finance, N. Kanakaratne, Ambassador to the United States, C. Cooray, Secretary, Ministry of Finance, H.E. Tennekoon, Governor of the Central Bank, N. Kappagoda, Director, External Resources Division, Ministry of Planning and Employment, L. Jayawardena, Director, Perspective Planning Division, Ministry of Planning and Employment, and S. de Alwis, Counsellor, Embassy of Ceylon, met with Mr. McNamara at 9 a.m. on September 26, 1972. Also present were Messrs. Cargill, Votaw, Cleveland, Roulet and Shibusawa.

2. Dr. Perera explained that the Cabinet had now reached a consensus on the long-awaited package of measures designed to increase Government revenues. At the core was the elimination of the free rice ration of 2 lbs. per person. To soften the blow, the Government proposed to introduce a scheme of family allowances of Rs. 40 a year per family member. This allowance which would take the form of interest bearing certificates would not be extended to income tax payers, nor to new entrants (which means that it would be eliminated gradually). In addition, the Government proposed to increase the price of flour by Rs. 0.05 per lb. and to subject all imports, other than rice, flour, fertilizer, drugs and infant food, to the surrender of foreign exchange entitlement certificates (FEECs). These measures taken together should, according to Dr. Perera, yield additional revenues to the tune of Rs. 350 million and enable Government to equilibrate its current account. In reply to a question, Dr. Perera said that he expected to include these measures in the 1973 budget scheduled to be presented on November 2. He added that Government had made a substantial public relations effort and that, in particular, these proposals had been discussed with the backbenchers who last year had forced Government to withdraw a number of budgetary proposals. As a result, Government was confident that the proposed measures would be accepted.

3. Dr. Perera stressed that Government was determined to reduce food imports and that, in particular, Sri Lanka was expected to reach self-sufficiency in rice by 1974. In reply to questions by Mr. McNamara, the delegation stated that the target originally set in the Plan was 1976, but that the date had since then been advanced. The Prime Minister had already announced that no imports of rice would be allowed after 1974.

President has seen

Present imports of rice amounted to about 250,000 tons, as against total production of about 1.1 million tons. To reach self-sufficiency would thus mean an increase of 20 - 25%, but the delegation noted that substantial progress had been made with new strains, that farmers' response had been positive, and that steps were being taken to improve the distribution of inputs such as fertilizer. Mr. McNamara commented that to aim at reaching self-sufficiency by 1974 was an ambitious target. Mr. Cargill, while noting Sri Lanka's good record with respect to research and extension services, pointed out that for the time being Sri Lanka still depended very much on monsoon rains. On this latter point Mr. Kappagoda pointed out that despite the severe drought experienced earlier this year, paddy production that had been expected to drop drastically managed to come back to the original target.

4. In reply to a question by Mr. McNamara, the delegation said that total food imports were currently at a level of about Rs. 700 million as against about Rs. 900 million two years ago. Since then imports of a number of subsidiary foodstuffs such as onions and chillies had been banned. Local prices were being determined according to the market; this had acted as a strong incentive for local growers.

5. Dr. Perera then turned to the question of Sri Lanka's need for financing and stressed that unless the pipeline was replenished quickly, serious cuts in imports of industrial materials would have to be envisaged early next year. During the current year, certain imports had already been curtailed and certain industries had only been allowed about 30 percent of their requirements. Until now the effect of these restrictions had been softened by the fact that enterprises could draw down their stocks, but these were now being depleted and, as a result, unutilized capacity was increasing. Mr. Cargill commented that the Government's failure last year to get acceptance of its proposed budgetary measures had had a serious negative effect on aid contributors. The U.K. and Japan, in particular, had stated at the Aid Group meeting last May that in present circumstances they were not in a position to make any announcement regarding further assistance. Being conscious of the urgency to review the situation in the light of Government action, which the Aid Group delegation had said would be taken shortly, Aid Group members had hoped that a meeting could be convened before the end of this year. Since the Government's proposals were now expected to be included in the new budget, this would clearly not be possible. The Bank planned to send a mission to review the budget around November 10, which should make it possible for the Group to meet early next year. In the Bank's view, Sri Lanka's imports should normally be of the order of Rs. 2600 million (about $400 million). Estimated total imports for this year were, however, expected at about Rs. 2300 million (about $360 million), with a slight increase for next year. This assumed, of course, that foreign assistance would be forthcoming which, in turn, would depend on the budgetary action the Government proposed to take. It was

generally recognized that if the measures were such as to restore a climate conducive to development, the Bank would be in a position to impress on Aid Group members the desirability of providing assistance quickly. In reply to a question by Dr. Perera, Mr. McNamara said that in present circumstances it was impossible for the Bank Group to consider making assistance available to Sri Lanka in the form of program loans since the first prerequisite was that the country should have a strong development program. If circumstances were to change, however, the Bank would, of course, be prepared to review its position.

6. With regard to exports, Dr. Perera pointed out that in the Government's efforts to develop non-traditional exports (i.e. exports other than tea, rubber and coconut products), a number of facilities were being made available and that progress was encouraging, particularly with respect to gems, fruit and fruit juices. He expected that for this year non-traditional exports should reach the level of Rs. 100 million.

7. In conclusion, it was recognized that while Sri Lanka needed substantial assistance quickly, much would depend on the revenue raising measures that the Government expected to implement. This was essentially a political problem which only the Government could solve. Dr. Perera stated that the Government had done considerable preparatory work and felt confident that the proposed measures would be accepted. In this connection he said, in reply to a question by Mr. McNamara, that the by-election scheduled for October 8 was not expected to have any influence on the Government's support in Parliament.

cc: Messrs. McNamara
Knapp
Cargill
Diamond
Weiner
Blobel
Baneth
Melmoth
Shibusawa
Cleveland

JDRoulet:dp

14

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Files

DATE: January 3, 1973

FROM: William Diamond WD

SUBJECT: Sri Lanka Aid Group

The Ceylonese Ambassador called on Mr. McNamara last night. He was accompanied by his Economic Counselor, Mr. de Alwis. Mr. Hablutzel and I were also present.

The Ambassador said he had been instructed by his Government to appeal to Mr. McNamara to have the Bank take the initiative in calling the Aid Group together. He said that he had informed his Government of our strategy (as described in the meeting two weeks ago with Mr. Cargill) of reporting to the Aid Group on Ceylon's deteriorating economic situation and of asking the Aid Group to decide whether it wanted to have a meeting. The Government feared that this would convey the impression that the Bank did not wish the Aid Group to meet and that this impression would be reinforced by the fact that there had been no Bank or IDA lending to Ceylon in the past several years.

Mr. McNamara said the Bank felt an Aid Group meeting was vital to Ceylon. As he understood it, the object of Mr. Cargill's letter to the Finance Minister and of my letters to the members of the Aid Group was to say that an interruption in aid would be disastrous for Ceylon, but that the justification for it rested not on economic development considerations but on the maintenance of political stability. We could not take the initiative of calling an Aid Group meeting on that kind of basis; but he thought we had left no doubt in the letters concerned of our conviction that a meeting was necessary. There was some discussion of the Ambassador's fear that the texts of the letters would not convey our real meaning. We undertook therefore to have a word with the Executive Directors representing each of the Aid Group members to make sure that there was no misunderstanding of our intention. This satisfied the Ambassador.

There was some discussion of the political problems confronting the Government and of the difficulty of taking the measures which the Ceylonese Government itself felt were needed. In this connection, the Ambassador noted that his Government had not questioned the economic analysis of the Bank Staff; nor had he, when Mr. Cargill spoke to him two weeks ago, questioned the conclusions of our mission or the wisdom of Mr. Cargill's line of action.

CC: Cargill
Baneth
Hablutzel
Shibusawa

WDiamond:phs

OFFICE MEMORANDUM

TO: Mr. Robert S. McNamara

DATE: December 29, 1972

FROM: William Diamond WD

SUBJECT: SRI LANKA: Forthcoming visit of Ambassador Neville Kanakaratne

Ambassador Kanakaratne has an appointment to see you at 6 p.m. on January 2, 1973. The purpose of the Ambassador's visit is probably to urge the Bank to convene an Aid Group meeting in Paris as early as possible in order to obtain new aid commitments.

The Ambassador visited Mr. Cargill on December 20 to make such a plea. Mr. Cargill said it would be difficult for the Bank to argue that aid to Sri Lanka would serve a developmental purpose unless we could report a substantial improvement in Sri Lanka's prospects for using new aid actually to promote development. Unfortunately, the findings of the Bank mission which visited Sri Lanka in November indicate that the intention of the Government to start tackling the fundamental ills of the economy has been defeated by the difficulties of political circumstances. The new budget has not succeeded in mobilizing the resources needed for a dynamic investment program, and the year 1973 is likely to end with negative public savings and public investments no higher than in 1972. Mr. Cargill concluded that the continuation of aid, especially commodity and food aid, while indispensable for Sri Lanka's capacity to import, could probably not achieve much more than postpone the day of reckoning. He added that it was clear that the arguments for continuing aid had to be made more on political considerations than on prospects for economic growth.

Mr. Cargill told the Ambassador that he would write to the Minister of Finance about our gloomy view of this situation, enclosing a copy of our economic report and suggesting that the Government discuss the situation with other Aid Group members. He also said we would write to the Aid Group members to obtain their reactions to the request of Sri Lanka for a meeting. We dispatched these letters on December 26. Attached are copies, and a copy of the economic report.

I suspect the Ambassador immediately called the Government about his talk with Mr. Cargill, and was instructed to carry the matter further, to you. He asked you for an appointment within 2 days of his talk with us. But I am not sure what he intends to accomplish.

I will attend your meeting.

Attachments

Cleared with and cc: Mr. Baneth
cc: Mr. Cargill (o/r)
Mr. Hablutzel
Mr. Cleveland

President has seen

AShibusawa/WDiamond:dp

December 26, 1972

Dr. N.M. Perera
Finance Minister
Ministry of Finance
Secretariat Building No. 1
Colombo
SRI LANKA.

Dear Mr. Minister:

You remember our conversations during the Annual Meeting. We then agreed that if non-project aid disbursements were not to be interrupted, new commitments were needed quite urgently, and to obtain them it was desirable to arrange a meeting of the Aid Group as soon as practicable. However, in view of what had been said at recent aid group meetings, we had also agreed that such a meeting would be productive only if we could report to it a substantial improvement in Sri Lanka's prospects for using new aid actually to promote development. You were quite hopeful that the 1973 budget, to be presented in November, would contain major resource mobilisation measures which, as we all have long agreed, are the most important single precondition for such improved development prospects.

I have now received the report of the mission headed by Mr. Rudolf Hablutzel, which visited Sri Lanka shortly after budget day. Quite frankly, that report has disappointed me. Once again, it seems that your intention to start tackling the fundamental ills of the economy has been defeated by the difficulties of political circumstances. The budget has not succeeded in mobilising the resources needed for a dynamic investment program, and the year 1973 is likely to end with a deficit and with investments comparable to those of 1972.

I fully realize the difficulties of the political situation confronting you. I also see that, once again, Sri Lanka has had a measure of bad luck in last year's drought and this year's rising world food prices. Because of this, further foreign aid may be entirely justified on the basis of humanitarian or similar considerations. However, it cannot be argued in the present situation, such as is described in our recent mission's report, that further foreign aid would serve the cause of economic development.

Yet the aid group, as you know, was established to promote economic development. In the past three years, I have appealed essentially to its patience, asking it in 1970 to wait until the elections, in 1971 to give the new Government time to master the situation and to recover from the insurgency, and in May 1972 to allow the Government to take the resource mobilisation measures then thought to be imminent. This time, I am somewhat at a loss as to what I shall tell the Group when it convenes.

Yet clearly, the need for new aid commitments is now getting to be extremely urgent. If there is much further delay, it will become impossible to prevent an interruption in disbursements and a substantial drop in their level over the year. You, of course, know better than I the very severe consequences this would have for Sri Lanka's ability to avoid major disruptions of consumer supplies and of production processes, and also for the budget. Though we cannot argue for new aid on development grounds, a meeting of the Aid Group may nevertheless be the best way of obtaining the new commitments which Sri Lanka so urgently needs.

If you share this view, I believe you should discuss the whole situation with other Aid Group members. We have written to point out to them the urgency of the situation (copy attached) and also sent them our draft Economic Report, to allow them to formulate an informed judgement as to their attitudes in this matter. If after such consultations, you feel that a meeting is desirable, I shall convene one.

I am sending a copy of this letter to H.A. de S. Gunasekera.

With best regards,

Yours sincerely,

I.P.M. Cargill
Vice President, Asia

Encl:

cc: Dr. H.A. de S. Gunasekera
Permanent Secretary
Ministry of Planning & Employment
P.O. Box 277
Colombo 1, Sri Lanka.

cc: Mr. Baneth
Mr. Hablutzel
Mr. Diamond
Mr. Shibusawa

December 26, 1972

Dear Mr. Nebot:

Please refer to the Report of Proceedings of the meeting of the Aid Group for Ceylon which took place in Paris on May 24, 1972.

I am enclosing a draft of a report written by the Bank mission which visited Sri Lanka in November. (Simultaneously, we have sent the same text to the Finance Minister of Sri Lanka.) I am sending it to you without the statistical appendices and before clearance within the Bank because we would like to get your reactions to it fairly soon. I do not think that further consideration of this report in the Bank will lead to any change in the conclusions.

It seems to us that the economic and financial position of Sri Lanka is likely to deteriorate further. The Government apparently found it politically difficult to take action at the time of the budget, which might have brought about an improvement. Accordingly, it seems unlikely that any significant development program can be started in the coming year.

This, of course, raises the question whether it would be appropriate to call another meeting of the Aid Group. The situation is quite serious because without the continuation of aid, especially commodity and food aid, Sri Lanka's capacity to import at a level sufficient to prevent serious disruptions will be much impaired. Indeed, any interruption in aid flows would quickly lead to a very critical situation. However, it is clear that the arguments for continuing aid are based more on political considerations than on prospects for economic growth. The Government of Sri Lanka asked that an Aid meeting be called as soon as possible - possibly in February - and I will be grateful for your Government's reactions to this request.

With best wishes,

Sincerely yours,

William Diamond
Director
South Asia Department
Asia Regional Office

Enclosure

Mr. Guy Nebot
Conseiller Financier
Charge des relations bilaterales du Tresor
Ministere de l'Economie et des Finances
93 Rue de Rivoli
75056 Paris RP, France

/See overleaf

cc: Mr. M. Vienot, Executive Director for France

Similar letters have been sent to other members of Sri Lanka Aid Group as follows:-

Mr. Neil Overend
Director General of Programming
Canadian International Development Agency
122 Bank Street
Ottawa 4, Ontario, Canada

cc: Mr. C.M. Isbister,
Executive Director for Canada

Mr. R.B.M. King
Overseas Development Administration
Foreign and Commonwealth Office
Eland House, Stag Place
London S.W. 1, England

cc: Mr. A.K. Rawlinson,
Executive Director for the
United Kingdom

Mr. Donald G. MacDonald
Assistant Administrator
Bureau for NESA - Room 6724
Department of State
Washington, D.C. 20523

cc: Mr. R.E. Wieczorowski
Executive Director for the U.S.

cc: Messrs. Baneth, Hablutzel, Shibusawa

IPMCargill:dp

15

OFFICE MEMORANDUM

TO: The Files

DATE: April 2, 1973

FROM: William Diamond W

CONFIDENTIAL

SUBJECT: SRI LANKA

1. Dr. N. N. Perera, Finance Minister of Sri lanka, visited Mr. McNamara, Monday afternoon, March 26, 1973. He was accompanied by the Ambassador of Sri Lanka; Mr. Lal Jayawardena, Additional Secretary, Ministry of Planning and Employment; Mr. Susantha de Alwis of the Embassy of Sri Lanka; and Mr. W. M. Tilakaratna, Alternate Director of IMF for Sri Lanka. Messrs. Knapp, Hablutzel and Diamond were also present.

2. The Minister reviewed in general terms the difficulty of Sri Lanka's present economic situation and the political constraints within which the Government worked. Reverting to Mr. Gunesekera's letter of early February to Mr. Cargill, he stressed the need for additional assistance from IDA. He cited the factors that complicated the situation of Sri Lanka, and, in particular, referred to the unexpected and spectacular increase in the prices of the foodstuffs and other essential commodities which Sri Lanka imports. He mentioned that the Government was compelled now to ration domestic wheat flour consumption. He referred at length to the goal of the Government of Sri Lanka to reduce rice imports to zero in 1975, if necessary by banning imports of rice. But, under prodding from Mr. McNamara, he was vague about the plans and the means of achieving this goal. Mr. Jayawardena offered to provide detailed documentation on progress made so far in the past in agricultural import substitution, as well as in the field of income distribution. The Minister said that he expected that his Government would, in the next few weeks, take an important step with respect to the exchange rate, involving an effective devaluation of about 18%, and would take steps to increase the prices of important food items now being subsidized, the end result of which would be a substantial improvement in the budgetary position of the Government. He referred to a paper given by Mr. Jayawardena to Messrs. Baneth and Hablutzel a week before (which purported to represent Mr. Jayawardena's own views at that time, and suggested three options for dealing with the exchange rate, the first and most modest of which was the one the Minister had apparently chosen). Even with these measures, a major difficulty that remained was insufficient foreign exchange for industrial imports, which could result in reduction of capacity in operation.

3. Mr. McNamara referred to the Bank's general posture on program loans but said that the Bank was prepared to consider one within the guidelines that had been laid down several years ago by the Executive Directors. He suggested that the Minister's staff and ours get together in the next day or so to review in detail the Minister's proposals for dealing with the problems that confront Sri Lanka.

4. On the following day, March 27, Mr. Jayawardena met with Mr. Hablutzel and others and reviewed in detail the proposals now pending. The results are reflected in Mr. Hablutzel's attached memo of March 29. In essence, the proposed devaluation, price increases and civil servant salary raises (which the Minister had not mentioned to Mr. McNamara) would, if carried out, constitute an important and effective package of measures to help counteract the extremely adverse situation which had developed in Sri Lanka. The new price measures would practically eliminate all food subsidies, other than for rice, by pushing Rp. 400 million of additional costs onto the consumer, and would move towards a more realistic price system. While the net budgetary effect would be a substantial improvement, it would result only in a small surplus on current account, not larger than the Rp. 56 million shown in the Bank's report of December 1972 before import price increases produced a drastic deterioration of the situation. While the result provided another evidence (of which we saw some earlier this year) of Sri Lanka's new willingness to deal with the critical situation, Sri Lanka would still not be appreciably better off in terms of economic development than it was at the end of last year. It was vital to think in terms of a substantial improvement in public capital formation for the 1974 budget. This, and related measures should be a subject of dialogue between IDA and Sri Lanka in the coming year.

5. On Wednesday, March 28, Mr. Jayawardena visited me. (I was already aware of some of the results of the previous day's meeting.) I was told that the change in the exchange rate was a matter that had been agreed in principle between the Minister and the IMF, and on which a decision was scheduled to be taken in the next two weeks, around the time the current IMF mission left Sri Lanka. As for the price increases (and the proposed increased wage rate), these were to be proposed to the Government on the Minister's return to Colombo this week. Mr. Jayawardena said that the memorandum he had given us the week before, representing only his own views, had been stimulated by the Prime Minister whom he felt would support the proposals and, therefore, he was confident that the new policy package would go through. I noted that, at best, the new package, while presenting an improvement, was basically a return to the situation of 4 months ago and that it still could not be characterized as a "development situation", therefore it would need to be followed by significant steps to increase the Government's investment program, if it were to become a basis for additional external support. Mr. Jayawardena said that it was precisely to discuss the kinds and timing of measures that needed to be taken in the future that his Government had invited Mr. Cargill to visit Sri Lanka. I told Mr. Jayawardena that I had learned that very morning that Mr. Cargill would be unable to visit Sri Lanka, because he was not well and had commitments that he had to see through before his return to Washington.

6. I then told Mr. Jayawardena that he should not be hopeful about the prospect of a program loan from IDA. I mentioned Mr. McNamara's comments on the general posture on the subject and said that I thought it would be extremely difficult to establish that Sri Lanka could yet satisfy the criteria for program lending. I noted that the Sri Lanka Aid Group, when it concluded its meeting in February in Paris, had said that, if there are significant improvements in the environment in Sri Lanka, it would be prepared to consider additional assistance. I said that, if our analysis of the Tuesday discussion with Mr. Jayawardena yielded favorable results, we would be prepared to call them to the attention of the participating countries of the Aid Group, as soon as we had confirmation that the measures had been put into effect. So far as IDA was concerned, we would also try to speed up the next project in the pipeline. But I could not hold out much hope of the program loan.

cc: Messrs. McNamara
Cargill o/r
Baneth o/r
Hablutzel
Pilvin
Shibusawa
Knapp

WDiamond:je

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. William Diamond

DATE: March 29, 1973

FROM: Rudolf Hablutzel RH

CONFIDENTIAL

SUBJECT: SRI LANKA - Program Loan and Policy Package

On March 27 I had meetings with Mr. Lal Jayawardena to explore the possibility of a program loan to Sri Lanka; Mr. A. Cleveland also attended throughout; and Messrs. Pilvin and Shibusawa part of the time. This was after the Minister of Finance, Mr. N.M. Perera had met Mr. McNamara and had made a request for a program loan, even though this had been done in extremely vague terms.

Regarding the need for program lending, it now appears that after taking account of the commodity aid pledges made at the recent Paris meeting, a substantial foreign exchange gap will remain if food consumption levels are to be preserved at or near current levels. There is extremely little scope for further compressing essential non-food imports such as fertilizers or drugs; other import requirements are essentially only for capital goods and industrial imports. Capital goods imports being in major part tied to supplier's credits and project aid, the only area of flexibility is in industrial imports, for which it now appears that foreign exchange will be available only to meet less than half last year's level. The gap is in the order of US$30-40 million, depending on whether the IMF will come up with a stand-by providing for gross drawings of $25 million as now contemplated, or just rolling over the $15 million that are due for repurchase in the 12 month's period starting this month. It is evident that failure to secure finance for imports of industrial raw materials would inevitably lead to widespread shutdowns, and a quantum jump in unemployment with grave political consequences. Mr. Jayawardena believes that the crunch will come sometime in the fall, but in my opinion it will be earlier than that.

The purpose of our meeting was to see whether the Bank could agree to a policy package that would be satisfactory as a condition for a program loan to finance industrial imports in the amount of, say, $20 million. The package which Mr. Jayawardena said would be proposed to the Cabinet around April 12 would consist of a) a devaluation of the Sri Lanka Rupee by 18% to establish a 1:1 parity with the Indian Rupee, while maintaining the existing FEEC system; b) upward adjustments of the prices at which the Government provides major food items under the subsidy system, and c) a 5% increase in wages in the Government sector. The reason for chosing parity with the Indian Rupee rather than any other degree of devaluation is that it would be the least conspicuous way of exchange rate reform; the wage adjustment is meant to be a concession in the face of rather substantial increase in the cost of living that will be caused by the price measures.

Mr. Diamond March 29, 1973

The price increases proposed would tackle the problem of rising increases in the cost of import prices for flour, sugar, and rice. They are as follows:

1. Increase the off-ration flour price from 37¢ to 69¢ per lb.
2. Increase the off-ration sugar price from Rs. 1.50 to Rs. 2.50 per lb.
3. Increase the ration price for dhal from 44¢ to 67¢ per lb.
4. Restore the increase in the price of the second measure of rice to Rs. 1.60 per lb., after it had recently been reduced to 1.40 per lb.

It must be remembered that all this would be on top of several measures that have already been taken earlier this year, when the price of flour was increased from 33¢ to 37¢ per lb., the sugar ration was cut by half and the price of the second measure of rice was adjusted from Rs. 1.00 to Rs. 1.60 per lb. With the assumed price elasticities, a reduction in consumption of sugar and flour is expected to result in some saving on imports by 20,000 tons (12%) in the case of sugar, and 113,000 tons (24%) in the case of flour. These reductions are, however, from levels that had been substantially revised upward in the case of flour after the Budget because of reduced availability of rice, and the shift of consumption to flour as a result of deliberately asymmetrical price increases enacted earlier this year.

The effect of these price measures on the Budget would be very substantial. The net cost of the total food subsidy in the original Budget was Rs. 605 million. After taking into account the increases in import prices in 1973, the estimate had been revised upward to Rs. 887 million. The proposed changes in domestic prices would bring the cost of the subsidy down to Rs. 438 million. Details are shown below:

(Rs. million)

	November 1972 Budget Estimate	March 1973 Revised Estimate	Estimate after Proposed Measures
Rice	-583	-663	-638
Dhal	-13	-16	-2
Import with	n.a.	-5	-5
Flour	-111	-212	+18
Sugar	+103	+9	+189
Total Net Subsidy	-604	-887	-438

The result of the proposed price measures would be an improvement in the budgetary position by Rs. 166 million compared to the original estimate in the November budget and discussed in the Bank economic report. On the other hand, the net budgetary effect of the devaluation would be a loss of about Rs. 87; the main reason for this is that it is proposed to collect only part of the increased value of the export duties on tea, rubber, and coconut in order to pass on a gain from the devaluation to these primary exporters; therefore, the increase in the cost of Government imports would exceed the increased yield of export and import duties and FEECs. The remaining budgetary savings from the combined package are proposed to be absorbed by a 5% increase in Government wages and salaries, so that the whole policy package would just restore the budget to its original position where it was estimated that a surplus on current account of about Rs. 56 million would be achieved.

It must be recognized that if the package were accepted and carried out the Government would have dealt with an extremely adverse situation where sharp increases in the cost of major imports were eroding the budget to the extent of over Rs. 280 million (and even more if some price measures had not already been taken). The new price measures would practically eliminate all food subsidies except for the first measure of rice, and restore a substantial profit on sugar, by pushing, in total, some Rs. 450 million as additional cost to the consumer. In this process, domestic prices would be adjusted to international prices in a significant degree (although not to the point of translating the present exceptionally high prices into domestic consumer prices at the effective rate of exchange). With a return of import prices to more normal levels, additional public savings would automatically rise by something in the order of perhaps Rs. 200 million p.a.

Another effect of the proposed package would be significant progress towards reduction of existing distortions in the domestic price structure, by improving prices for major exports on the one hand, and those of imported cereals and sugar on the other, thereby improving the incentives for further agricultural import substitution.

I indicated to Mr. Jayawardena that we would consider such a package as a substantial effort by the Government towards creating a more realistic price system, and towards mobilizing more domestic resources, even though the present circumstances made it impossible for this effort to show up in the form of a greater volume of public savings compared with the November budget. We had pointed out in the memo to the Aid Group that the amount of resources that Sri Lanka had lost through adverse movements in international prices in two years has far exceeded the total resources that we had earlier proposed would need to be mobilized by the Government to bring about a favorable environment for economic development. We did, therefore, recognize that simply to restore a small surplus in the 1973 budget would be an achievement of major importance. Nevertheless, we did not think that on this basis alone it would be possible to make a case in the Bank for a program loan since in effect Sri Lanka would still not be better off in terms of economic development than in the status quo ante as described in the economic report, at least as far as public savings were concerned.

Therefore, we would need to have assurances for further steps being taken at a later stage to improve on a performance that the economic report had described as rather disappointing.

As to the nature of such steps, I said that we would consider it indispensable for the 1974 budget to produce a surplus large enough to permit a substantial increase in public capital formation in real terms. Questioned on the magnitude of such an increase, I said that in current 1974 prices an investment program of Rs. 1.5 billion would be extremely desirable. Mr. Jayawardena on his part suggested that a 10% increase in the program would be more in line with the Five-Year Plan. To this I commented that the Five-Year Plan might not be the best guide at this stage for a satisfactory level of public investments, and indicated that we might discuss any figure between Rs. 1,200 and Rs. 1,500, taking account of whatever other measures would be contemplated. One important element in fiscal improvement I said would have to be a reduction in the losses incurred by public corporations and enterprises, and containment of general recurrent expenditures.

As to the nature and procedures for an understanding between the Bank and the Government of Sri Lanka on further steps to be taken subsequent to the package of measures presently envisaged, we agreed that this should preferably be discussed at the highest political level.

cc: Messrs. Pilvin
Shibusawa
Cleveland
Baneth (o.r.)

RHablutzel:go

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. Robert S. McNamara

DATE: March 16, 1973

FROM: I.P.M. Cargill

SUBJECT: SRI LANKA - Forthcoming Meeting with Minister of Finance

Since sending you my briefing for your forthcoming meeting with Minister Perera, I have learned that we had a visit today from Dr. Lal Jayawardena, Additional Secretary, Ministry of Planning and Employment, who will accompany the Finance Minister for his meeting with you. He asked about the possibility of program lending to Sri Lanka. He was told we could contemplate such an operation only if the Government adopted a drastic policy package which laid a basis for future economic development. Such a policy package should, at the very least: move to the present FEEC rate for all trade except the three major exports, which also should benefit from a higher effective exchange rate; revise upwards domestic prices (except for the three major export commodities) so that they should at least equal import price levels converted at the FEEC exchange rate; take appropriate budgetary action to maintain at least equilibrium of the current budget after these price changes so as to get some hope of generating Government savings once foodgrain import prices come down to more normal levels. In addition, though not as a part of the policy package, it would be desirable for the Government to clarify in its own mind how it will stabilize current expenditures. Dr. Jayawardena outlined several proposals that he had discussed with the Finance Minister, that would serve as a starting point for putting together a policy package, mainly in the area of exchange rate reform. We said that, as we now understood these proposals, they would not be far reaching enough, but indicated our willingness to study them in more detail and continue the discussion.

Given the very informal nature of this preliminary discussion, in your meeting with the Minister, you might wish not to raise the issue of a program credit and the associated policy package with the Minister, unless he would bring it up himself.

RHablutzel/JBaneth:myc

President has seen

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. Robert S. McNamara

DATE: March 16, 1973

FROM: I.P.M. Cargill

SUBJECT: SRI LANKA - Forthcoming Meeting with Minister of Finance

1. Dr. N.M. Perera, Finance Minister, Sri Lanka, is scheduled to call on you at 6:30 p.m. Friday, March 23. He will be in Washington from March 22 through 28 to attend meetings of the Committee of Twenty on International Monetary Reform and the Inter-Governmental Group of Twenty-four on International Monetary Matters. His c.v. is attached as Annex 1.

2. I do not know what topics Dr. Perera may bring up for discussion with you. However, I would like to draw your attention to the fact that, during the Sri Lanka Aid Group meeting, which took place in Paris on February 22, the donor countries, as well as Sri Lanka, accepted the conclusions of the Bank's recent economic report and the updating memorandum that, although the measures taken by the Government are in the right direction, they are inadequate to give the country any real impetus towards development.

3. The level of new assistance indicated by the Aid Group is about \$60 million. Although this is larger than last year, it is nevertheless far short of what is required just to maintain in 1973 the reduced import capacity of 1972. The Bank has estimated that disbursements of about \$64 million in commodity aid would be needed from new commitments to be made in 1973; disbursements at that level would require new commodity aid commitments from the Aid Group of well over \$100 million. Assuming the usual lag between commitments and disbursements, the \$60 million of Aid Group pledges might be expected to generate at most \$35 million of disbursements in 1973, or slightly over one-half of the required \$64 million. The Government is thus faced with continued deterioration of the economy which is likely to reach a critical level before the end of this calendar year unless Sri Lanka is able to obtain short-term financing to cover the gap. The prospects of Sri Lanka's obtaining such short-term financing under the present circumstances are not very bright.

4. Attached, as Annex 2, is a copy of a letter I sent today to Dr. Perera in which I underline the grave situation that is likely to confront Sri Lanka before the end of 1973. I wrote this letter because a grossly erroneous impression appears to have been created in some quarters of the Government that Sri Lanka will not be faced with any serious economic problems this year as a result of the \$60 million pledge obtained during the Aid Group meeting in February. Dr. Perera should be brought back to earth.

5. Attached, as Annex 3, for background, is a copy of our report on the Aid Group meeting.

Attachments

AHShibusawa:dp

DR. N.M. PERERA

Dr. Perera is a veteran politician. Founder and leader of the L.S.S.P. Party, he has served in Ceylon's Parliament since 1936 (except between 1940 and 1945 when his party was banned and he himself imprisoned), and was leader of the opposition in the House of Representatives in 1947-52. He was Minister of Finance in Mrs. Bandaranaike's government from June 1964 to March 1965 and in this capacity attended the Bank/IMF Annual Meeting in Tokyo. During that period, relations with Ceylon began to improve and it was with Dr. Perera that the discussions which subsequently led to the establishment of the Aid Group were initiated. Among the present Cabinet members, he is a more conservative and moderate element.

Born in 1905, he was educated in Colombo and at the London School of Economics. He received doctorate degrees in both law and economics from London University.

South Asia Department
March 16, 1973

ANNEX 2

March 16, 1973

Dr. N.M. Perera
Minister of Finance
Ministry of Finance
Colombo
Sri Lanka

Dear N.M.:

I would have liked very much to have seen you on your forthcoming visit to Washington next week to discuss matters of common interest, but unfortunately I will be away at that time. I am therefore writing to you now in order to make sure that there is no misunderstanding between us on the way in which we interpret the results of the recent meeting of the Aid to Sri Lanka Group, and the problems which your Government is facing this year.

I understand that the press in Sri Lanka has described the results of the meeting very favorably, and conveyed the impression to the general public that the amount of aid promised by the donor countries was very satisfactory, with the implication that it would resolve, in essence, Sri Lanka's external resource problems in 1973, and was a favorable reflection of the Group Members' views on how things are going in Sri Lanka. I understand that this has also been the tenor of the Government's own interpretation.

Given the rather critical comments that have been made in the Bank's economic report, and the subsequent uncertainty regarding the willingness of the Members of the Group to come forward with substantial financial assistance, I have sympathy with a sense of relief expressed back home at the outcome of the meeting. I think, however, that it would be dangerous at this stage for anybody to take an attitude of complacency, and particularly for the Government to lose sight of the fact that the level of aid that is going to be available this year is falling very substantially short of the requirements, even for maintaining the present slow pace of the economy. As you are now no doubt well aware, the value of foreign aid will be much less in real terms than what the figures suggest because of the steep increase in prices of major imports. We had calculated that in order only to maintain last year's level of non-food imports which was already cut down to a bare minimum to keep economic activity going, the amount of new commodity aid commitments would have to be about twice the amount that now seems likely to be forthcoming during 1973.

We continue to view the immediate outlook for Sri Lanka economy with very grave concern, and I think personally that before summer there are likely to be increasing shortages of imported goods of all kinds leading up, almost certainly, to severe price pressures, reduction in industrial production, widespread shutdowns, and more unemployment. The situation is so grave that courage will no doubt be required by your Government again to take new and politically unpopular measures in the course of the next several months to deal with the deteriorating balance of payments situation. With regard to the budget, I need not point out to you that as things stand at present, the position for public investment and savings is even worse than what it appeared to be at the time the budget was presented, and when the economic report was written. In other words, public savings in 1973 will again be negative, and the prospect is for a decline in real capital formation in the public sector even from the very low level of 1972. In short, the outlook for development is sharply deteriorating and the balance of payments problem is reaching a crisis proportion.

While it was generally recognized by the members of the Group at the Paris meeting that adverse external circumstances this year are inflicting real losses on Sri Lanka's economy, the view was also unanimously expressed that the Government's efforts towards resource mobilization were again inadequate, even though the new revenue measures, if considered per se, appeared substantial. The view was expressed that it had been the recurring experience in past years that adverse circumstances were forcing the Government to take certain positive actions, but that those actions tended to be last minute responses to the pressure of events and never outgrew the circumstances to become an independent force for development.

The meeting explicitly concurred with the analysis and comments of the Bank's economic report and the memorandum circulated to the Group, and the aid offers were made with the clear understanding that they reflected the wishes of the Member Governments to express their continued sympathy with the people and the Government of Sri Lanka, and were not in the nature of development assistance. On the other hand, the view was expressed more fully than last year that it was necessary for the Government of Sri Lanka as soon as possible to shift the emphasis of the whole of economic policies from welfare to production.

I trust that this, in a general way, is also your sense of the substance of the Aid Group Meeting, and that you agree with the underlying diagnosis of the economic situation.

Let me say once again that I would have much preferred to exchange views with you orally, but I hope to see you on another occasion in the not too distant future.

With warm regards,

Sincerely yours,

I.P.M. Cargill

IPMCargill/RHablutzel:go:plc

16

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. Robert S. McNamara

DATE: July 26, 1973

FROM: William Diamond W

SUBJECT: SRI LANKA - Your forthcoming meeting with the Minister of Finance

7/27

1. Dr. N.M. Perera, Minister of Finance of Sri Lanka, has an appointment to see you at 5:30 p.m. on Monday, July 30. He will be accompanied by Ambassador Kanakaratne.

2. You will recall that Mr. Cargill had discussed the Sri Lanka situation with you last week subsequent to sending you his two memoranda (copies attached). Following the discussion with you, we sent Mr. Baneth to Sri Lanka and we hope to receive from him by early next week an indication of the situation as he sees it. However, we are not certain if this will be received before your meeting with Minister Perera.

Attachments

AHShibusawa:dp

cc: Mr. Knapp
Mr. Cargill
Mr. Diamond

President has seen

M No. 57

INTERNATIONAL DEVELOPMENT ASSOCIATION | INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT | INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. R. S. McNamara

DATE: July 17, 1973

FROM: I. P. M. Cargill

SUBJECT: Sri Lanka

1. I am attaching a note giving you the background of the current extremely difficult economic position of Ceylon, and describing the actions I am proposing to take. Unless new foreign exchange resources are obtained rapidly, productive imports would have to be cut back sharply by the autumn, which would of course further depress production, employment and incomes. Despite repeated declarations of intent to the contrary, the Government has not initiated the drastic policy changes needed. The IMF feels that it cannot grant a standby unless a minimum package of actions is implemented; and unless such a package is implemented, we could not justify a program credit. The Aid Group too is unlikely to come up with additional aid for the current year, though it might possibly decide to do so to palliate the political consequence of an economic crisis. I believe, however, that in the absence of a drastic change in Ceylon's policies, even if all these sources came forth with aid, this would merely delay but not reverse Ceylon's economic decline.

2. I propose to send Mr. Baneth, assisted by an IMF staff member, to Ceylon for about one week. They will obtain a more precise evaluation of the situation, including that of the magnitude and timing of the aid needed to avert a crisis. They will also try to work out, on the basis of their discussions, a precise set of policy measures which could be deemed to constitute a minimum package. They will discuss their findings with the Government and report on them to me. I shall then pursue this discussion with Finance Minister Perera when he visits Washington at the end of the month. I am not at all hopeful of a positive outcome. I shall in any case report on the situation to the Aid Group to let them decide the course of action they wish to follow in the light of overall, including political considerations.

Attachments

cc: Mr. Knapp
Mr. Chenery

aneth/jas

OFFICE MEMORANDUM

TO: Mr. R. S. McNamara

DATE: July 17, 1973

FROM: I. P. M. Cargill

SUBJECT: Sri Lanka

Economic Background

1. From 1945 to about 1960, when its terms of trade were at their best, the Government of Ceylon instituted far-reaching social programs, whose main elements were free or subsidized distribution of various basic foodstuffs; free health and education; and subsidized public services (notably transport). These programs were financed essentially by means of taxes on major exports, levied directly or through the foreign exchange system. The combination of these measures had undoubtedly a beneficial effect on income distribution.

2. Ceylon's terms of trade were at their best levels in the 1950-1955 period, declined moderately until 1960, and sharply thereafter. In 1960, the three major export crops - tea, rubber and coconut products - contributed well over two-thirds of the real value of commodity production. Their weighted average prices declined in all but two years since 1960. In 1970, national income would have been almost 10 percent higher, and the total value of commodity production 18 percent higher, if export prices, in dollars, had remained at their 1970 level (disregarding possible indirect multiplier effects). Since 1970, particularly since late 1972, the weighted average price of Ceylon's main exports has recovered somewhat in dollar terms, but this modest improvement has been much more than offset by the dramatic rise in the price of imports. In particular, foodgrain, sugar and petroleum prices now stand respectively about 75, 120 and 50 percent above their 1970 average levels.

3. As effective taxes on the three major exports were raised to compensate for their falling values, the tax burden stifled producers to the point that export volumes have stagnated since about 1965, even though, for rubber and coconut, the foreign demand facing Ceylon cannot be considered inelastic. In the last few years, the tendency has been reinforced by bans on imports of various subsidiary foodstuffs (chilis, onions, etc.), whose prices rose to a multiple of world prices, thus encouraging movement of labor, fertilizer, etc., from the export commodities towards them. In the mid-1960's, a rice production program was started, which was quite successful at first. Rice production more than doubled from 1966 to 1970, but has never again reached that peak, under the combined impacts of inadequate pricing, administrative mismanagement and bad weather. Some remedial policy measures have now been taken, however, and the next crop may well show considerable improvement.

4. Social expenditures and food subsidies kept expanding with population and, more recently, with the rising prices of key imports. This tended to reduce the resources available to Government; public savings have been negative at least since 1970. Since the electoral victory of the present Government, policy measures and the tone of Government pronouncements have been such as to discourage

private investment in all but a few selected sectors (notably those connected with tourism). Government investment never again reached, in real terms, its 1969 level which, even in combination with quite buoyant private investment (fed by excessive foreign borrowing) was not enough to prevent the emergence of a serious unemployment problem.

5. In 1969/70, 40 percent of those aged between 17 and 24 were unemployed, including over 70 percent of the "O" level high-school graduates within this age group. Unemployed educated youth made up the bulk of the insurgents against the Bandaranaike Government in the spring of 1971. Several thousands of them are still behind barbed wire, but even excluding them, the number of unemployed must have continued to increase.

6. Another important aspect of the Ceylonese situation is the extreme distortion of the price system.1/ This is in large part a consequence of the Government's *ad hoc* reactions to the pressure of events: controlling the price and distribution of certain commodities, imposing Foreign Exchange Entitlement Certificates (FEEC) on certain imports, granting them to a few exports, varying the lists, banning this import or that, granting compensatory subsidies to certain outputs, etc. For instance, because of the effective export tax, coconuts sell locally for less than 50 percent their world market price (converting foreign prices at the FEEC rate). Therefore, coconut farmers get subsidized fertilizer. Chili and onion imports having been banned, their prices rose to three times the world price. It can only be guessed how much of the subsidized fertilizer actually reaches the coconut trees. In any case, the Ceylonese authorities are now seriously concerned that the country may become a net coconut importer before the end of the decade.

The Aid Group

7. Discussions about the establishment of the Ceylon Aid Group were initiated in 1964 under the previous Bandaranaike Government. By the time the first meeting was held in 1965, however, general elections had taken place and a new Government headed by Dudley Senanayake had assumed office. During the following years, Ceylon received the bulk of its assistance through the Aid Group. By the end of 1971 commitments by its member countries reached a cumulative total of nearly $310 million of which $260 million had been disbursed. About $240 million of these were commodity aid, disbursed at an annual average

---

1/ Also noteworthy are the confusion of the budget and of economic accounts. The very real difficulties created by the multiple exchange rate system and the criss-cross of taxes and subsidies, combined with some administrative laxity, make it very difficult for anybody - including the Government - to know what is truly happening in the economy.

of about $40-45 million. By contrast, most other countries provided little usable aid in recent years, with the exception of China which made a $25 million free foreign exchange loan in 1971.

8. Initially, Aid Group members felt encouraged by some of the measures taken by the Government. However, it became increasingly apparent towards the end of the sixties that only modest real progress was being achieved. From mid-1968 onwards, even that was threatened by excessive short-term foreign borrowing. However, political considerations (the proximity of the general elections of 1970) suggested that assistance by the Aid Group should be continued. At the April 1971 Aid Group meeting, members did not wish to upset relations with the new Government. There was also a good deal of sympathy with it, notably because of the serious and unexpected insurgency it had recently faced. Thus, members expressed their willingness to continue providing assistance for the time being.[1/] However, they warned that unless Ceylon reestablished a basis for development, it would be extremely difficult for them to give further assistance.

9. At the 1971 meeting, the Ceylonese Finance Minister gave assurances that adequate progress would be made, saying that the insurgency had convinced the Government that action would have to encompass areas so far considered taboo. In fact, however, even the inadequate measures included in the October 1971 budget had to be withdrawn under pressure from backbenchers. Repeated advice for urgent action (including that given to the Prime Minister by you when you visited the country in January 1972) was met with promises of action to be taken as soon as some approaching hurdle was overcome (the Republican constitution which changed the country's name to Sri Lanka, land reform legislation, bye-elections, etc.). In fact, no major action was taken, though minor measures, such as modest raises in the sugar and rice prices, etc., were implemented.

10. Nevertheless, the Aid Group met again in March 1972. The Government promised to take adequate action before the autumn, and the Group agreed to reconvene before the end of the year to consider pledging. During the 1972 annual meeting, the Finance Minister urged that the Aid Group be convened at the earliest; although no action had yet been taken, a major set of measures would be forthcoming at Budget time. Consequently, a small economic mission visited Ceylon, after the Budget was presented in November 1972. It reported that substantial additional revenues were indeed mobilized, notably through a rise in the FEEC rate from 55 percent to 65 percent - which is equivalent to devaluation combined with an increase both of the effective tax on major

---

1/ Except for Germany which, because of Ceylon's recognition of the German Democratic Republic the previous June, said they were not for the time being in a position to provide further assistance.

exports and of the effective subsidy to food imports. However, these revenues were mostly going to be absorbed by rising current expenditures. Moreover, correcting for the rise in food import prices which had already occurred but was not adequately reflected in the Budget, and for over-optimistic assumptions on the level of dutiable imports, the improvement shown by the Budget estimates was not likely to materialize. The major decision, described to the Staff by the Finance Minister in the course of the September discussions, i.e., the replacement of the free rice ration by a cash allocation limited to the population now living had not, in the event, been presented to Parliament.

11. To avert an immediate payments crisis, the Bank nevertheless convened a meeting of the Aid Group. It argued that Ceylon had once again suffered from a large measure of bad luck. Price rises added about $46 million to the cost of essential food imports. Though some other imports were reduced, in order to maintain imports of capital goods and industrial inputs at the already compressed level of the past few years, an over $30 million rise in commodity aid disbursements was needed in 1973 (from $59 to $92 million) even if the IMF also provided a substantial net drawing. Most Aid Group members expressed their extreme disappointment at the failure of the Ceylonese economy to show any sign of improvement. In the event, they pledged about $60 million - more than in some previous years, and indicated their readiness to consider additional pledges if the Government took the drastic policy steps which the situation required. Given the tardiness of the pledging and the small amounts then remaining in the aid pipeline, actual aid disbursements were likely to fall in 1973.1/ Furthermore, though Ceylon has obtained a SDR 18.6 million compensatory drawing from the IMF on June 20, 1973, it could not reach agreement with the Fund on a further normal drawing. Given the repurchases due this year, it will overall have to make some net repayment to the Fund.

Recent Discussions and the Current Situation

12. The Finance Minister and the Managing Director of the IMF did actually reach agreement on a minimum policy package. One element of this was a modification of the exchange rate: raising the official rate to parity with the Indian Rupee, i.e., by about 18 percent, granting FEECs to coconut and rubber exports, and offsetting through export taxes not more than 50 percent of the consequent increase in the gross return to these commodities. However, these measures were in fact not implemented. The IMF now sees no possibility of granting an additional standby, nor any advantage in pursuing conversations, until the agreed package is implemented, and the authorities also express their intent to implement a basic fiscal reform aimed at achieving a substantial current surplus.

13. Since Budget day, the Government has taken several additional measures. Notably, in June 1973, the price of flour was raised from Rs. 0.38 to Rs. 0.48 per pound, that of non-rationed sugar from Rs. 1.50 to Rs. 1.65 per pound, and the price of milk products by 30 to 40 percent. According to the Ceylonese

1/ Disregarding exchange rate changes, whose overall impact we cannot yet assess.

authorities, these measures will bring the Government budget back into the slight nominal surplus indicated in the original Budget estimates.[1] We cannot evaluate this contention, for despite repeated requests we could not obtain the necessary background information. However, these price rises may not even fully reflect import price increases, and may therefore be unlikely to contribute to the generation of a budget surplus. However, given the pervasive role assumed by the Government, even these inadequate price increases (milder than those experienced by consumers in many neighboring countries) focus consumer dissatisfaction directly on the Government.

14. Even if the overall nominal budget surplus had been achieved, it would have been far from enough to generate the investment levels which would allow Ceylon even to make a movement towards reversing the downward course of its economy. This is all the more so as some of the recent measures (notably import bans and the increase in the FEEC rate) have further aggravated price distortions.

15. Import demand remains vastly in excess of what can be financed. Unless new resources become available, a fairly drastic compression of imports will have to be achieved at the latest by about the autumn. For lack of precise balance of payments information, we do not know the magnitudes involved; we can merely guess that the compression needed would be of the order of about $30 million, bearing mainly on current industrial imports which were about $130 million in 1972. Such a compression of industrial imports would substantially affect production, employment and income levels. To achieve this compression, licensing would have to be drastically tightened right about now; or, to put it differently, licenses must be issued in the very near future if such a compression is to be avoided. Of course, licensing can proceed without creating major short-term difficulties later only if reasonable financing can be secured now under the form of a large IMF drawing, IDA program credit, Aid Group commodity assistance, or a combination of all this.

16. Ever since January of this year, various Ceylonese officials, including the Finance Minister, have taken the opportunity of their participation in the Group of Twenty meetings to press for an IDA program credit. We have repeatedly explained the minimum package of measures that the staff would consider essential in order to propose such a credit to Management (see attached note). In essence, they consist in the generation of enough new public revenue to eliminate the effective current budget deficit, without the help of the accounting device which counts part of aid receipts as current

1/ Nominal, in the sense that a major revenue item in that budget consists in FEECs and other duties levied on aided imports. Counting aid receipts at their FEEC rate, even the budget estimates were in heavy current deficit.

revenue; and some movement towards reducing price distortions. This roughly corresponds to what the Fund Staff considers to be the preconditions for a new standby. At various times, various officials showed themselves more or less ready to discuss such a package, though no concrete progress has been made. As noted above, the Finance Minister and the IMF did in fact reach agreement on a program, but the measures were not implemented.

Proposed Action

17. The Ceylonese have nevertheless kept pressing for a program credit. We have been unable to obtain from them the information necessary precisely to assess either the current budgetary situation (including the impact of the measures already taken), the magnitude of the looming balance of payments crisis or the precise formulation of the minimum package program which - in conjunction with additional aid to be mobilized - could give some hope of ultimate recovery. In these circumstances, it is possible neither to recommend a program credit to you, nor to recommend additional assistance from the Aid Group on economic grounds. I have said this to the Ceylonese authorities on several occasions in the past few weeks. I have also noted that, with only SDR 18.6 million of IMF funds assured, even the addition of a new IMF drawing and of an IDA program credit would together only buy a few months of time, and still would not in time create the new development environment Ceylon needs.

18. The fact remains, however, that the situation in Ceylon verges on the desperate. It is possible that many in high places in Ceylon do not fully appreciate the seriousness of their plight. In any event, I think the time has also come once again to bring the facts to the attention of the Aid Group.

19. I am therefore planning immediately to send Mr. Baneth to Ceylon for about a week. I shall ask the IMF to allow Mr. Premchand, of their Fiscal Affairs Department, to accompany him; he is the person most knowledgeable about Ceylonese budgetary procedures and the arcane presentation of the budget accounts. They will review the present economic position and evaluate the minimum additional aid needed to avoid a crisis, and its timing. This calls for information which, despite the visits of high Ceylonese officials, we have not been able to obtain. While we do not now know the amounts needed, they are likely to exceed the resources conceivably available from IDA and the Fund, and to require additional funds from the Aid Group. Mr. Baneth will also examine, in terms of specific taxes, exchange rate movements and subsidies, the potential elements of a minimal program of measures which, if implemented, would allow Ceylon to create a modest development situation. He will also discuss the situation with Ceylonese officials, both at the civil service and cabinet levels, in an effort to get them to appreciate the need for emergency action. I then propose to discuss this program with the Finance Minister who will be in Washington for the next Group of Twenty meeting at the end of July.

20. I would be less than frank, however, if I were to give the impression that a positive result is likely to ensue. My experience suggests that we shall not be able to reach agreement even on a minimum acceptable package of measures to mobilize resources and to correct price distortions. I shall advise the Aid Group of the facts of the situation (including a report on Baneth's mission). I shall consider asking it to meet informally. My purpose would be to discuss the situation with the Group and to put the case of Ceylon in the only form in which, in my opinion, assistance can be justified: Do the members of the Group wish to see an economic and possibly political crisis in a country in South East Asia? If not, there is a political case for large-scale emergency help.

21. It is only fair to add that, in preparation for the Ceylon Aid Group meeting in February, I put the situation more or less in these same terms. The Group pledged more than in most past years, but well short of the level needed for this year. Six months have gone by without improvement in the situation. The prognosis is then no better today than it was in February, and probably worse. This may move the member countries of the Aid Group.

Attachment

SRI LANKA: INDUSTRIAL IMPORTS CREDIT

1. This note outlines the nature of the actions that, if taken by the Government, would enable Bank staff to recommend to management an industrial imports credit in calendar 1973. The end-result of the policy actions indicated below should be to achieve (i) in the present budget year, a major improvement in the extremely unsatisfactory budgetary outcome now in prospect; (ii) an economic environment that will stimulate production and exports; (iii) a resumption of development through a satisfactory level of public investment and savings.

(a) Achievement of the first objective - improved budgetary performance - will require, in the main, measures to raise tax revenues and reduce current expenditures, the latter in large part through significant reduction of food subsidies.

(b) Accomplishing the second objective - stimulating lagging output and exports - will primarily require introduction of realistic effective exchange rates. These should assure that non-traditional exporters be given significant price incentives, while exporters of traditional products (coconut, rubber and tea) also receive remunerative prices.

2. To create a development situation will require considerable public savings, of the order of, say, Rs. 400 million at 1971 prices. This should allow public sector investment of the order of Rs. 1,200 million at 1971 prices. Presumably, such a situation will more easily come about once the Government's declared intention to stop rice imports and eliminate rice subsidies in 1974 has been implemented, provided the price of wheat flour is also appropriately raised so as to prevent a shift in demand from rice to imported foodgrains. Achievement of this target will also necessitate substantial improvement in the financial performance of state enterprises. This, in turn, will require appropriate price and rate adjustments, and, where necessary, measures to improve efficiency.

3. Obviously, this program will have to be implemented in a phased manner. An appropriate first step might consist in a combination of measures which, once implemented, would bring current Government revenues (not including FEECs levied on aided imports) into equilibrium with current Government expenditures over a full 12-month period.

4. Before the staff could recommend a credit to the management, it would be essential for us to have a broad outline of the measures proposed by the Government, including numerical estimates of their anticipated budgetary effects, and their proposed timing. We would also need to see that at least the first step, described in paragraph 3, has been implemented.

5. We would also need a list of the industrial imports to be financed, along with a description of their uses.