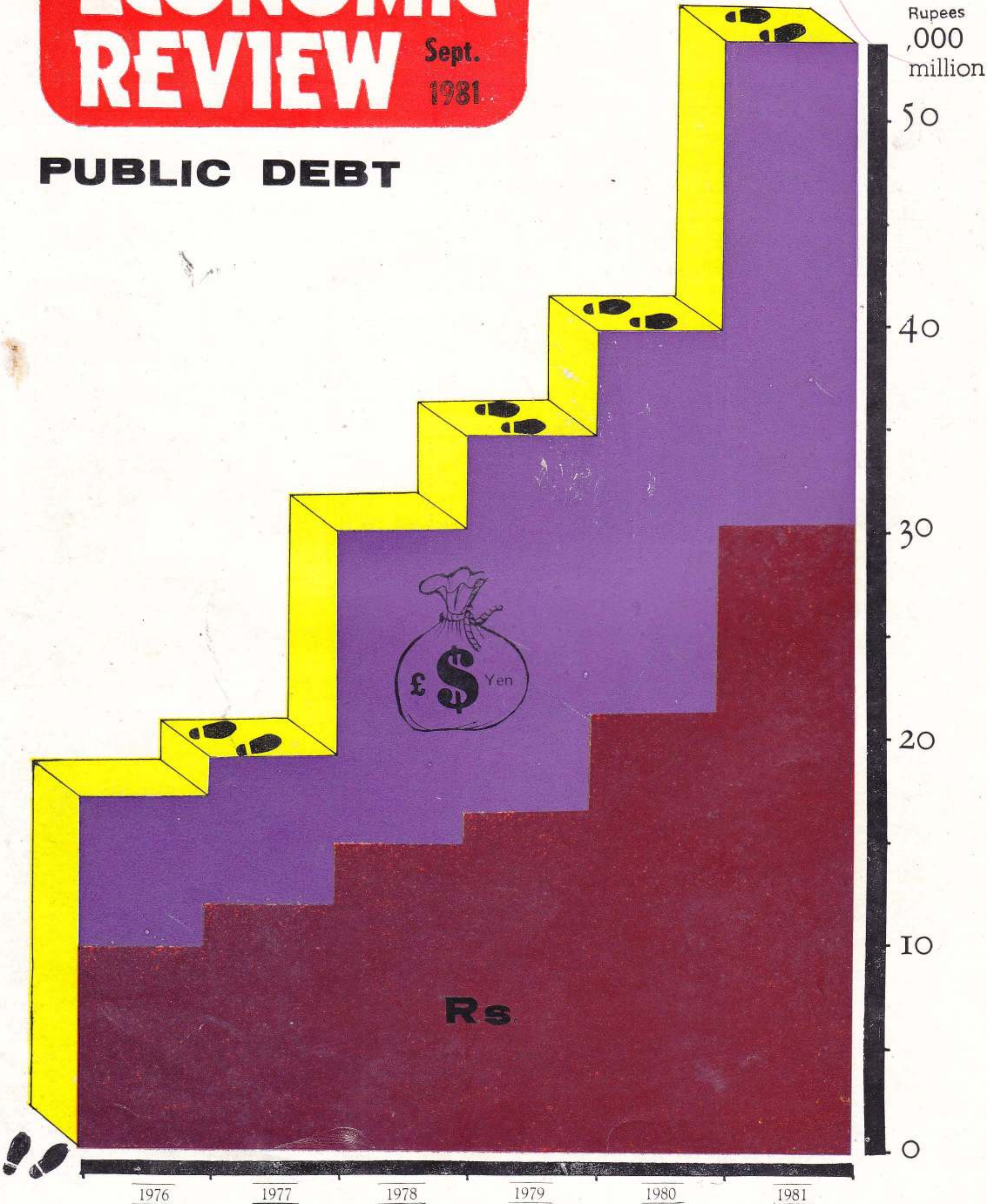
ECONOMIC REVIEW

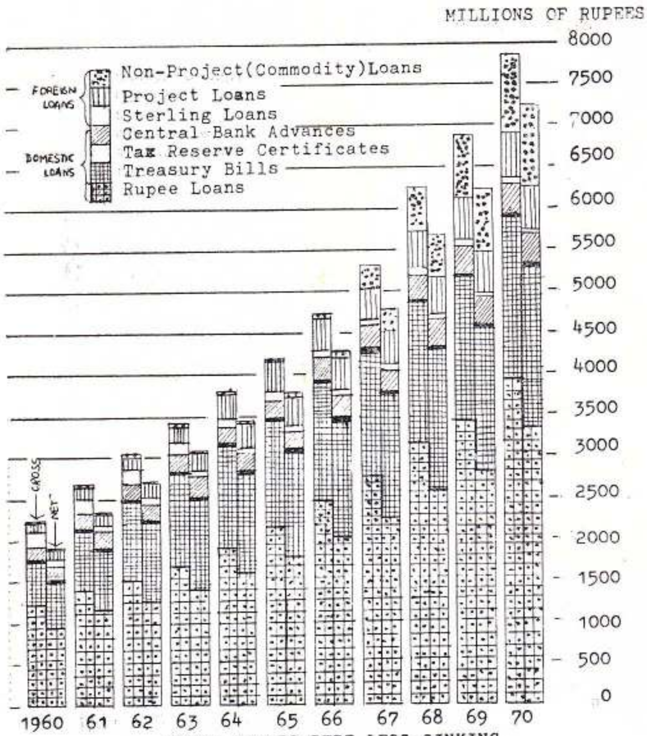
Sept. 1981

PUBLIC DEBT



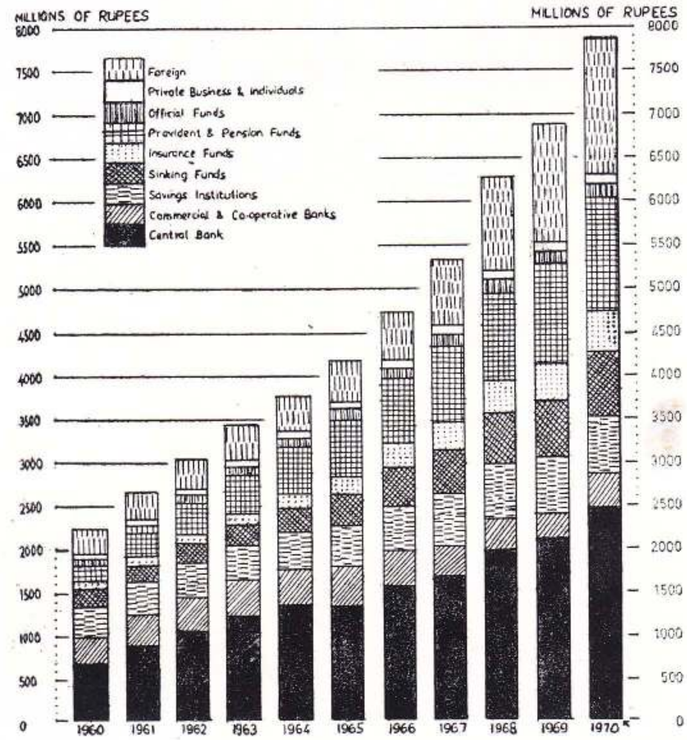
THE CHANGING DEBT SITUATION

COMPOSITION OF PUBLIC DEBT
(SHOWING GROSS & NET* PUBLIC DEBT)



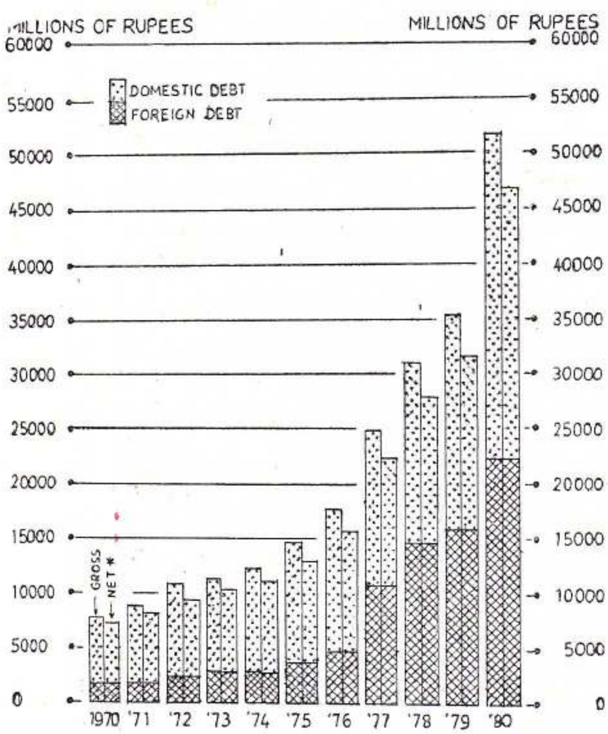
GROSS PUBLIC DEBT LESS SINKING FUND
Financial year ends 30th Sept.

OWNERSHIP OF PUBLIC DEBT.

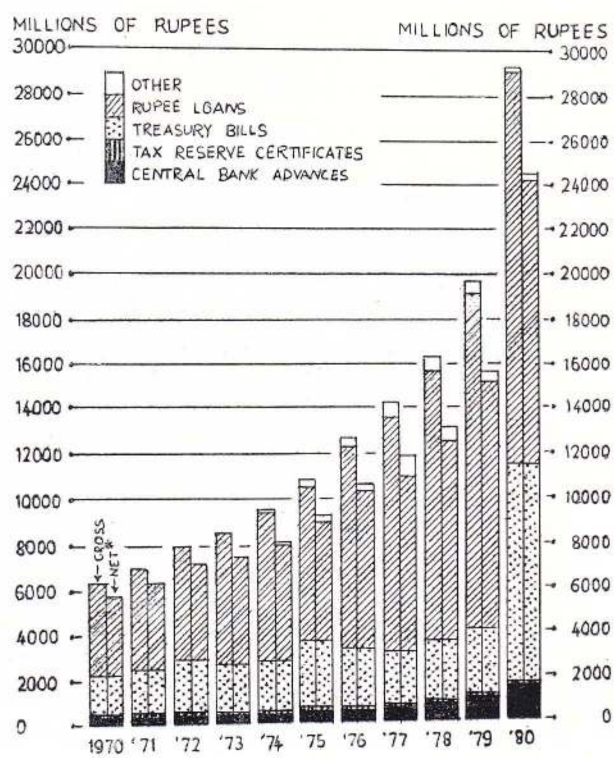


Financial year ends 30th September.
* Provisional

COMPOSITION OF PUBLIC DEBT



COMPOSITION OF DOMESTIC DEBT



* Gross Public Debt Less Sinking Funds

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THE ECONOMIC REVIEW is intended to promote knowledge of and interest in the economy and economic development process by a many sided presentation of views & reportage, facts and debate.

THE ECONOMIC REVIEW is a community service project of the People's Bank. Its contents, however, are the result of editorial considerations only and do not necessarily reflect Bank policies or the official viewpoint. Signed feature articles also are the personal views of the authors and do not represent the institutions to which they are attached. Similar contributions as well as comments and viewpoints are welcome.

THE ECONOMIC REVIEW is published monthly and is available both on subscription and on direct sale.

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- Education and Development–An Analysis of the Sri Lanka Situation
- Role of Pawning in the Market
- The Budget

COVER

Palitha Kannangara

Diary of Events

July

8 The Government raised the authorised limit on Treasury Bills from Rs. 10,000 million to Rs. 13,000 million, by a resolution adopted in Parliament. The earlier Rs. 10,000 million limit had been adopted in December 1980.

10 A sum of SDR 37.5 million (approximately Rs. 825 million) was drawn under the IMF's Extended Fund Facility (EEF) arrangement. With this drawing, Sri Lanka has obtained a total of SDR 185.0 million under the EEF arrangement.

15 The International Development Association signed an agreement with Sri Lanka for a loan of SDR 24.8 million (approximately Rs. 586 million) to finance the Village Rehabilitation Project, designed to rehabilitate 1,200 village irrigation and minor irrigation schemes by the Department of Agrarian Services, with a view to improving water management programmes.

Sri Lanka will receive a grant of Canadian Dollars 30.5 million (approximately Rs 475.5 million) according to an agreement signed with the Canadian International Development Agency. The proceeds of the grant will be used for the purchase of fertiliser.

17 The Asian Development Bank will grant Sri Lanka a loan US Dollars 10.0 million (approximately Rs. 187.4 million) for a project to be undertaken by the National Development Bank (NDB) for financing by the NDB of specific industrial development projects by disbursing loans for productive purposes in the public and private sectors and also for the provision of consultancy services.

21 The government reduced the export duty on rubber by a Gazette Extraordinary notification in order to provide margin to producers. The operative floor price applicable to ad-valorem export duties was increased from Rs. 8/50 to Rs. 10/- per kilo; while for FOB prices ranging from Rs. 17/- to Rs. 20/- the new duty rate was 75% as against a previous 50%. This results in a foregone government revenue of an estimated Rs. 300 million per annum.

August

5 The Government agreed to a recommendation from the Minister of Finance that the terms of an Eurodollar loan of US $ 75 million, negotiated by his Ministry with the Chemical Bank of America syndicated jointly with the Bank of Tokyo and Indo-Suez Asia Ltd. be accepted. This loan has been negotiated to support the Balance of Payments for 1981.

The Cabinet accepted in principle an "urgent and essential forestry development programme estimated to cost Rs. 56.8 million between 1982-86. A further US $ 5 million World Bank loan, for financing this programme, is to be negotiated.

13 In view of the prevailing low export prices (f.o.b.) the Government withdrew the specific export duty of Rs. 1,650 per metric ton levied on coconut oil. This measure is expected to provide a reasonable margin to exporters of coconut oil.

15 Import duty levied on the import of live horses, asses, mules and hinnies was reduced from Rs. 20,000 to Rs. 5,000 per animal.

17 The Central Bank of Ceylon increases the bank rate — the rate of interest on advances to commercial banks secured by the pledge off Government and government guaranteed securities — from 12 per cent to 14 per cent per annum. However, the Refinance facilities for exports remained unchanged at the prevailing rate of 12 per cent.

19 The Cabinet agreed to a recommendation of the President, in his capacity as Minister of Power and Energy, that a Committee be set up to consider the constraints on power and energy supplies and study and report on the options available to the Government. It was noted that severe power shortages could occur over the next three year and early measures were very necessary.

21 Saudi Arabia will hold its oil prices at $32 a barrel until the end of next year, Saudi Oil Minister Shiekh Yamani announced at the end of an OPEC meeting in Geneva. At the same time, Saudi Arabia, responsible for about half of OPEC's output, decided to cut production in September by 1 million barrels a day to 9 million barrels per day, reported the London Financial Times.

26 The Government approved a tender for the Rs. 217 million administrative complex of buildings in the new capital at Pelwatte to a British Construction firm, on the recommendation of the Prime Minister.

27 The ADB in Manila and IFDA in Rome will loan US $ 12 million and US Dollars 8 million respectively towards a US $ 30 million (approximately Rs. 575 million) project aimed at increasing the production of coconuts from smallholder's plantations and improving quality of their products, the Secretary of the Coconut Industries Ministry announced. Under this 5-year project 17,000 acres of coconut land are to replanted, 65,000 acres rehabilitated and 3,500 acres intercropped.

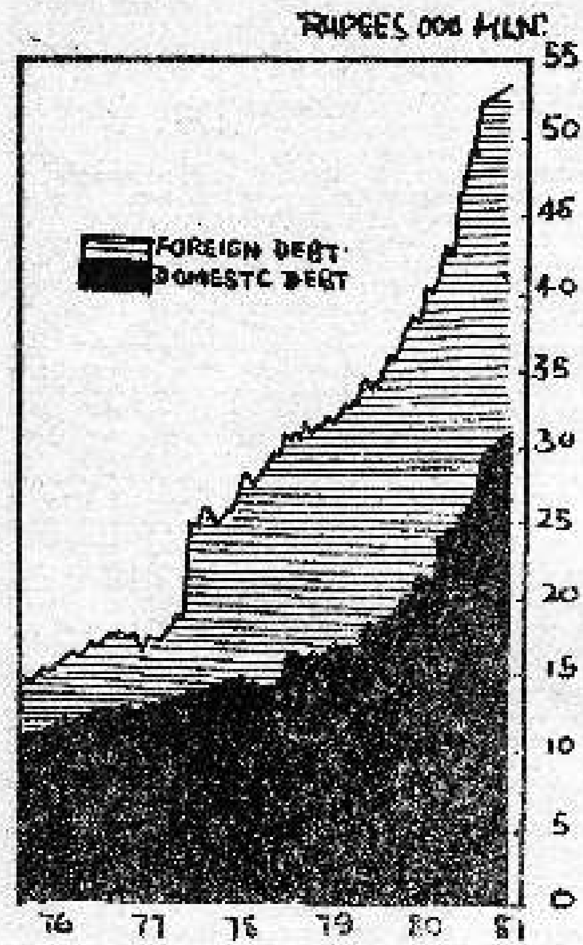
The latest four week session of the UN Conference on the Law of the Sea ended in Geneva with delegates from 150 countries confirming that they will conclude the treaty in April next year with or without US participation, reported the London Financial Times.

The Monetary Board of the Central Bank announced the rules it framed under Section 10(2)(I) of the Control of Finance Companies Act No. 27 of 1979, whereby finance companies soliciting deposits from the public through advertisements are required to furnish specific information to their prospective depositors. These rules come into effect from 1st September, 1981.

Challenges and Sacrifices: An Assessment of the Growth of Sri Lanka's Public Debt in the Light of Debt Theory

S. T. G. FERNANDO

Dr. Fernando was Director of Economic Research, Central Bank, before he assumed duties recently as Chairman, People's Bank. The views expressed in this paper are those of the author and in no way represent the view points of either the Central Bank or the People's Bank.



PUBLIC DEBT (GROSS) MONTHLY.

A quick assessment of Sri Lanka's economic performance, though not urgently, is yet, opportunely called for as a convenient background to see the recent growth in public debt. It is now almost four years since the experiment of a liberalised economy was initiated. The policy objectives, aspirations and results of this economic experiment require closer study. One fact is clearly discernible. The contrast between the pre 1977 and post 1977 economic environment is marked.

The gains todate are considerable and deeply satisfying. The new economic policies have paved the way for a freer economy; an economy exhibiting a drastic reduction or complete elimination of a wide array of controls, licensing and paper work to permit market oriented operations of production, resource allocation and distribution. Out of this new arrangement has arisen the signalling system of relative prices based on comparative costs and scarcity value, prices designed to stimulate new activities while throwing into bold relief the inefficiency of protectionism and sheltered enclaves. There have been singularly remarkable strides made in fostering export activities, in banking and in commerce and in the mobilisation of domestic savings, the latter through interest rate profiles which have made financial investments an attractive proposition. Above all there has been a breakaway from a fixed and intransigent development plan to a more practical and relevant rolling plan based wholly on the Capital projects of the public and corporate sectors.

The acceptance of an investment programme for 1981-85 has outlined in time perspective, the contours of a massive capital development programme linked to four lead projects. All these gains and achievements have been worked out amidst the most turbulent of economic circumstances and adversities. Critics of liberalisation have not hesitated to draw parallels from the experience of the previous regime of controls to argue for welfarism and restraint on growth or profits in the national accounts. The relative shares or distribution of profits and wages in the national account is only partially determined by the degree of monopoly and rate of profit on capital. In a developing situation besides the relative shares of income, labour and capital, the expanding size of the national income resulting from the process of development is worthy of attention. It is this apparent result which is swept aside, ignoring in other words the years of stagnation and stagflation which pervaded nearly all spheres of economic activities in the seventies.

The economic scenario of turbulent circumstances which rocked so severely and dangerously the economic programme of the Government in 1979 and more dramatically in 1980 were conditioned by the gloomy world economic situation. What were the economic circumstances in the world outside which so perversely conditioned the economic performance of the export-import economy of Sri Lanka? To the rude economic shocks of the early seventies caused by the first oil price hike, unpreparedness to meet such an eventuality, protectionism and conservative monetarism, the late seventies witnessed the painful economic adjustments of third world developing oil importing countries to the global recession permeating the industrial countries. High and upward swings in energy costs, unpredictable, fluctuating and volatile foreign exchange movements of key currencies, dampened world trade growth, lagging demand for primary products, sharply declining prices of primary products are some of the more immediately relevant circumstances.

It has been remarked that the eighties would reveal an equally dismal scenario of poverty and painful adjustments for the poorer non oil producing developing countries. In 1981 unfavourable developments are predicted on the basis of estimates made by the world monetary and lending institutions. It would appear that Balance of Payments deficits would have to be covered increasingly by additional debts abroad. Because of the high interest rates in industrial countries, the terms for future borrowing will remain unfavourable prompting poorer countries, least able to withstand such burdens to have recourse to commercial borrowing in sheer desperation to avoid defaults on obligations. The servicing of existing debt would be a further burden with the result that even the securing of new loans would be difficult. In such gloomy circumstances the line up for immediate debt relief and grants and highly concessional terms of development assistance would lengthen, unless the world scenario were to change dramatically.

While the circumstances leading to debt negotiations for rescheduling of relief altogether would depend on individual country situations and stabilisation measures to be implemented, the fundamental circumstances for such a predicament could be traced to balance of payments deterioration and through same for excessively expansionary fiscal and monetary policies. Worsening terms of trade, export shortfalls, reduction in inward remittances, reduction in tourist earnings and a hardening of borrowing terms leading to higher servicing costs are likely to figure importantly as influencing the balance of payments situation and the resource gap. A further unsatisfactory trend has to be underlined, namely the disagreement now openly witnessed between Debtors and Creditors for re-structuring external obligations and the continuing disagreement on the length of the consolidation period and terms of repayment. These factors make it likely that the external debt problem would remain with the poorer countries, and Sri Lanka, too, would despite her heroic efforts to hurry her programme of development be faced with debt servicing problems of an excruciating character. The study of Sri Lanka's public debt growth and its assessment is therefore likely to be relevant and urgent.

The management of public debt has assumed increasing importance and economic significance in recent years because of the increase in magnitude of public borrowings. The significance of this growth has to be assessed in the perspective of certain key macro-economic relationships. Paragraphs following are devoted to such an examination.

As at the end of December 1980, the gross public debt of Sri Lanka stood at Rs. 51,655.6 million as against Rs. 7,873.2 million in September 1970, Rs. 3,787.4 million in September 1964 and Rs. 1,145.0 million at the end of September 1954. This growth in public debt can be conceptually related to the value of gross domestic product at current factor cost prices and the ratio (more appropriately, total net public debt to G.D.P.) is reckoned as a convenient indicator of the weight of public debt. The ratio measures the servicing cost of such debt and elucidates through capital-output functional relationships whether government capital expenditures (which are financed mainly from public borrowings) have contributed to higher productivity and the growth of gross domestic product. The relationships of net debt to G.D.P. are worked out for three periods namely, 1959 to 1964, 1970 to 1974, and 1975 to 1980. It is seen that in the period 1959-1964 total net public debt averaged 38.01% of G.D.P., in the period 1970-1974 it averaged 55.7% and total net debt for the recent period 1975-1980 revealed a phenomentally high figure of 65.2%. In other words, gross domestic product has in money terms at current factor cost prices risen at a slower rate than net public debt and the servicing cost of public debt in terms of real resources appears to have grown heavier in view of the differential rates of growth of the two items.

Resources absorbed to finance public debt are necessarily higher in the 1970-74 and 1975-80 periods as compared with 1959-1964. The acceleration in the period 1975-80 is most marked.

There are strikingly marked differences of opinion on the economic effects of an increase in public debt. Where there has been close scrutiny of public debt theory it is evident that differences of views prevail as to whether they are a blessing, a curse or a matter of indifference. Discussions of deficit financing for economic development have revived this issue but apparently have done barely anything to settle it. Those adherents following the Keynesian frame-work of analysis have favoured deficit financing and have dismissed the question of the "burden" of the debt in later years with the general statement that an internally held debt imposes no economic burden. On the other hand, those who have made special studies of the latter question and who favoured the classical methodology of reasoning, monetarists with inflationary and purchasing power theorus find themselves admitting that inflation makes the burden of debt less severe on future generations. Nevertheless, they argue for control of money supply and inflation thus discussing the growth of public debt in terms of real output and productivity growth, to arrive at a different conclusion. The statistical trends noted above are seen in Table 1. *

The principal factor underlining the increase in magnitude of public borrowings has been the expansion in total payments of government. The expenditure of government, current and capital outlays, has been increasing faster than the ability to mobilise financial resources by way of taxes, profits of nationalised ventures, borrowings of real savings of the public and revenue receipts secured through other fiscal and budgetary devices. The insufficiency of total receipts to match total expenditure has necessitated the running of large and increasing budgetary deficits (cash operating deficits) and the financing of these deficits has been through continued recourse to public borrowings from both bank and non-bank sources.

An examination of financial statistics of budgetary outlays would reveal that the totals of current receipts of government have increasingly fallen short of total payments. In the period 1964-65 to 1974 as well as 1977 to 1981, the unfinanced gap i.e. total payments of government minus current receipts, has shown a regular increase. The gap in 1964-65 was Rs. 463.8 million, this had reached Rs. 1,146.8 million in 1974 and Rs. 14,617.6 million in 1980 (provisionally estimated). The trend observed for the sixties and to date is in contrast to the performance in 1954-55 when total current receipts exceeded total payments by Rs. 173.3 million and the gap in 1955-56 was as small as Rs. 63.7 million. In Table 2 relevant financial data are presented in a manner (1) to reveal the financial gap between total payments and total current receipts (2) the extent of direct borrowing resorted to by government to cover the financial gap. From an economic standpoint of relating capital formation (ie. construction and maintenance of real assets) to budgetary outlays and for an assessment of government's fiscal policy it is necessary to adopt a different classification, so as to calculate the extents of capital expenditures of government which have been financed through borrowings. Loan finance of real capital formation (as against acquisition of financial assets) adds to productive capacity and helps to self liquidate the

* For tables refer page 12 onwards

debt incurred for financing it. In Table 3 (a) the contributions of current account surplus as available for financing capital expenditures and (b) the extent of net domestic borrowing utilised to finance capital expenditures are brought out.

A striking feature brought out in the calculations has been the very small contribution made by way of current account surplus in recent years towards financing capital expenditure and the concomitant heavy reliance on direct borrowing for this purpose. It is also a reflection of the general reluctance to use the tax system to mobilise revenue.

The corollary of this fact is that the government has increasingly relied upon public borrowings as well as foreign finance, including grants of capital transfers, for meeting capital expenditures. It is also observed that on occasions government has borrowed in excess of its requirements for capital expenditure with a view to adding to its cash balances. In the financial years 1970-71, 1971-72, 1979 and more recently in 1981 there had been deficits even in the current account, which required the government to borrow for meeting those deficits. Note in contrast the performance in 1955-56, 1956-57 and 1957-58. Budgeting in these three years had permitted substantial current account surpluses to be realised so as to reduce very considerably the dependence on public borrowings. It is apparent that the trend at present is to depend increasingly on public borrowings to finance capital expenditures.

Most developing economies are faced with the problem of enlarging the public sector and transferring resources for economic growth. Sri Lanka is no exception. Public borrowing has become a necessary instrument for such resource transfers. It is politically more acceptable than taxation. The economic effects of borrowing on the general price level and on product growth are much the same in a poor developing country in so far as economic effects are broadly concerned. Taxation or deficit financing which helps to keep the general price level high and rising affect the masses adversely and painfully until such time as output growth is evident. Even then the extent of the amelioration would depend on the composition of output flowing from the investments undertaken. The importance of public borrowing and management of public debt in the tasks of resource mobilisation can be shown in three important respects.

Firstly, there is the inescapable fact that government must borrow in order to ensure adequacy of fiscal resources for implementing its development programme. Even if there is no specific economic plan, annual (budgetary) capital expenditures are usually programmed over a period of years and the search for funds to finance these without interruption places on the government a heavy responsibility.

Secondly, a government through public borrowings is in a position to influence the liquidity of the economy and thereby the state of monetary stability. Most governments are averse to permitting a state of inflationary expectations and price increases to continue without checking, since as inflation results in reductions in incomes of those whose incomes are not subject to price compensatory revisions. Cost push inflation invariably sets in motion wage-price spirals which governments wish to avoid dealing with. The extent to which the liquidity of the economy is affected and influenced through public borrowings depends from whom and which sectors the government borrows and the nature and term structure of securities offered.

The liquidity effect will be greater or weaker depending upon whether government borrowing from the banking system is more or less and whether such borrowing is on securities of very short term with a high nearness to money or long dated stock. For ensuring adequacy of financial resources borrowing from the banking system may be unavoidable but it may at the same time pose problems of a different order as regards liquidity, inflationary expectations and monetary stability. One of the problems a government faces in resorting to public borrowing is that of striking a balance between these effects and adopting policies to mitigate the consequences.

Thirdly, government is called upon to issues securities to provide avenues of investment for those who rank safety of principal and certainty of interest income as overriding considerations in the selection of financial investments. A large and active security market is one of the objectives which government endeavours to foster. It is a recognised fact that a government has to borrow from the public to supplement resources to meet its financial obligations. If a government could use the means of taxation and raise larger sums through profits of public enterprise its reliance on public debt and borrowings can be reduced and recourse to deficit financing for fiscal purposes can be significantly reduced. Expressed differently, if expenditure targets are set in conformity to availability of resources from taxation and profit transfers, the growth of public debt can be minimised. Such a course of action is not possible as the rate of growth of expenditure tends to outrun the rate of growth of income and profits siphoned to the government. The figures in Table 4 in this respect, underline very firmly that in an increasing trend growth of total payments the contribution made by taxes in absolute terms in recent years has shown only a modest increase and that too of a relatively small order. Between 1977 and 1980 while current payments increased by 224 percent the relative increase in total taxes was 127 percent with the result that the share of tax covering total payments fell from 62.61% to [illegible], the lowest registered for the span of years examined. Direct borrowings have been resorted to as the tax effort has not been sufficiently large enough to fully meet total payments. While taxes and total borrowings together have shown upward movements, taking the period 1955/56 to 1980 as a whole it is seen, that the percentage of borrowings utilised to cover total payments has been on the increase, baring 1973 and 1974 and this underlines the re- to raise taxes to levels high enough to contain or reduce dependence on public borrowing.

While the growth of public debt can be traced to the magnitude of the budgetary gap and the character of budgetary policy followed all of which are subsumed under the heading of 'fiscal policy', the form of financing resorted to, the type of securities issued. The rates of interest offered and the term structure of securities made available to the investing public for subscription are relevant for appraisal of Government policy and fall within the scope of monetary policy. The movements and characters of these instruments have a direct bearing on the level of liquidity of the economy. The scope of public debt and its influence, therefore, extends from fiscal policy at one end to monetary policy at the other and the area of influence of public debt management on economic matters is therefore unusually wide. It is pertinent to sort out for policy formulation those aspects of public debt policy which are infact measures originating from government per se and those of which are generally within the control of the Central Bank. In all these measures (1) influence the size, composition and distribution of public debt, (2) alter the level and term structure of interest rates, supply of money and liquidity of the economy, (3) determine the timing, mode of borrowing, refinancing and conversion operations and (4) influence the volume and extent of trading in marketable securities.

Sri Lanka's public debt, as remarked earlier, has shown a steep and spectacular increase. It is clearly useful to single out the more important characteristics of the present debt position before discussing the necessity, if any, for making changes therein. The term 'public debt' in this paper refers to the domestic and foreign borrowings of the government of Sri Lanka only, excluding therefrom the debt of semi-government institutions such as debt of public corporations and local authorities. Likewise external suppliers' and acceptance credits, Central Bank borrowings from foreign governments and lenders abroad are excluded from foreign debt coverage.

At the end of December 1980, the gross public debt stood at Rs. 51,655.6 million having recorded an increase of Rs. 16,180.9 million (45.1%) over the previous year. Of the gross public debt outstanding in 1980 Rs. 29,378.8 million (56.9%) comprised domestic rupee debt while the balance 43.1% or Rs. 22,276.8 million rupees was foreign borrowings. The more important trends of public debt growth distinguishing between gross and net debt and foreign and domestic components in this debt are given in Table 5.

During the last four financial years, i.e. since 1977 there has been a steady increase in the foreign debt component of public debt. In 1967-68 gross foreign debt accounted for 17%, in 1974 24% and by 1980 the share had increased to 43% of total gross public debt. While the absolute increase in domestic debt has been marked in recent years, proportionately the increase in foreign debt has been higher. This higher trend rate of growth of foreign debt is explained largely in terms of increased dependence on external assistance in financing imports of government sources, the high import content of capital expenditures and more generally the acute foreign exchange resource gap facing the government.

The increases recorded in foreign debt in recent years have to be interpreted with certain reservations of a technical nature. Consequent to the linking of the Sri Lanka Rupee with the Pound Sterling on first October 1972, the parity rates between the Sri Lanka Rupee and foreign currencies were revised from time to time by the Central Bank of Ceylon. As the Pound Sterling was allowed to float against other currencies, the Rupee equivalent of foreign debt denominated in foreign currencies other than in Sterling was re-calculated with parity changes. Some order of the change involved is worthy of note. Such revaluation of debt resulted in an increase of Rs. 200 million and a decrease of Rs. 39 million in Sri Lanka's foreign liabilities in 1973 and 1974 respectively. The devaluation of the Sri Lanka Rupee in November 1977 and the floating of the rupee has no doubt increased the rupee equivalent of Gross and Net foreign debt.

There are certain economic considerations concerning the growth of foreign debt which require to be stressed. The increase in foreign debt primarily reflects the heavy dependence of public sector expenditure on foreign exchange on the one hand and the country's inability to expand export earnings satisfactorily on the other. Leaving aside the difficulties brought about by adverse terms of trade and the debt servicing problems resulting from a shrinkage of export earnings, it would appear that the only satisfactory way of servicing the repayment of foreign obligations is through the creation of export surpluses. Unlike a rupee debt held internaly, the growth of foreign debt raised an entirely different set of problems.

The creation, servicing and subsequent retirement of rupee debt involves basically a transfer of resources (real and monetary) between private and public sectors. These transfers could have monetary effects which may be inflationary under certain circumstances, but nevertheless are manageable and within the framework of policies influenced by the Central Bank. When a foreign debt is incurred and expenditure is financed from such resources there is no transfer of real resources from the private sector to the public sector. The transaction enables goods and services in the debtor country to be increased and there is a supplementation of real resources. In effect the country is enabled to increase the flow of supplies all round with the minimum of current costs and hardships. Utilisation of foreign debt, however, creates obligations of repayment and servicing. The servicing and repayment of foreign debt has to be by way of external resources and this requires the creation of export surpluses or savings of import outlays. It is possible to utilise to a limited extent new foreign exchange loans, to repay previously contracted debt, but this exercise cannot be carried over an indefinite period of time. A time would come when foreign debt has to be serviced in foreign currency.

The pertinent issues when evaluating the utilisation of foreign debt are to bear in mind (1) the productivity of investments financed from foreign borrowings and (2) whether the export sector is being developed fast enough and large enough in the context of a commercial policy suited for this purpose for the realisation of export surpluses. The experience of most developing countries is that foreign loans have been utilised (a) for consumption purposes, (b) for infrastructure outlays and, (c) for the creation of or expansion of industries producing import substitutes. While such investment activities, in general can produce the beneficial effects of making available a wide variety of goods than would otherwise have been possible, infuse and spread technical know how and skills and also provide new opportunities for investment, the impact of all such activities on the export sector unless the activities financed are directly export biased, the creation of export surpluses would be small. Besides, the buoyancy of the domestic market arising from a general stimulation of investment activity has been to stimulate domestic sales in preference to exports. The sales of goods at home enable quick returns and an easing of liquidity and traders opt in such instances to direct sales to domestic sources thus reducing the chances of realising export surpluses. Besides there has been a noticeable failure on the part of Governments to impose a lien on export earnings or import expenditures saved through domestic substitution programmes for servicing, amortization and repayment of foreign debt contracted. Resultantly, foreign financing does not except in theory generate export surpluses in the absence of some export control and regimentation.

Sri Lanka's increase in foreign debt and the servicing obligations are problems common to other developing countries pursuing policies of structural transformation and accelerated economic growth.

A World Bank study on External Debt (EC 167/74) commented that between 1967 and 1972 the debt outstanding of developing countries increased at a rate of 14.6% per annum and that there had been a hardening in lending terms and consequent increase in the future debt servicing obligations of developing countries. The report stated "A number of countries had reached the point during the late 1960s and 1970s where they were unable to continue meeting their debt servicing obligations as originaly scheduled and had to arrange for debt relief...Countries .... face the problem of adjusting to sharply adverse movements in their terms of trade.

"The problem may be more difficult for countries whose exports are largely composed of primary commodities.....and this adjustment will be particularly hard for countries with very low income levels". In a more recent pubilcation EC 167/80 the World Bank commented that total medium and long term debt outstanding of the developing countries rose by 16% during 1979. Though higher than the rate 14.8% referred to the performance in 1979 reveals a significantly improved position from the average annual rate of growth of 23% in 1974-78. Sri Lanka's relative position in the 'debt league' is seen in the figures given in Table 13.

The increase in domestic debt in absolute terms has been quite substantial in recent years. The composition of domestic debt and its changes during the period 1968-69 to 1974 and 1977-1980 are summarised in Table 6.

Borrowings effected through the issue of rupee loans, barring the exception in 1980 have accounted for 50% of the increase in total domestic debt. In the composition of domestic debt since 1970 relative shares of the several items showed a near constancy with rupee loan stock accounting for 70-74%. Treasury Bills next in importance averaged 21%, Central Bank advances 5% and Tax Reserve Certificates 1%. The fiscal events of 1979 and 1980 disrupt this long standing pattern and were the outcome of special circumstances which necessitated the Government increasing its reliance on Treasury Bills as a means of budgetary financing. When compared with the fiscal performance of 1960s, the fiscal and debt management policy followed since 1938 reveals that the government was averse to an increase of the level of Treasury Bills outstanding and to use these as the principal means in financing budgetary deficits. It is an indication of financial restraint and a desire to contain the magnitude of inflationary financing. In fact a classification of public debt outstanding into two classes "floating debt" and "funded debt", the former comprising Treasury Bills, Tax Reserve Certificates, Central Bank advances and National Development Bonds and latter including Rupee Loan Stock would reveal that the share of floating debt (consisting mainly of Treasury Bills) in 1978 decreased to 30%, the lowest proportion recorded since 1959-60. The heavy and unusual recourse to Treasury bill financing both in 1979 and 1980 should be seen in the light of the severe resource constraint faced by Government. In 1980 in particular, the Sri Lanka economy was subject to very heavy pressures in the task of aggregate demand management. The economic policy pursued by the Government was basically a "big push" within the general framework of an open and liberalised economy. The public sector investment projects particularly the four lead projects gained momentum in 1980 and demanded a higher share of resources than previously planned. As the growth of resources (revenue) lagged seriously behind the growth of expenditure and events in the money market inducing the private sector to claim an equally large share of mobilised savings, the government seriously trapped in a resource constraint of major proportions was left with no choice but to resort to bank borrowing on an unprecedented scale particularly from the Central Bank. These came in the form of fresh issues of Treasury bills. The effect on the economy of Government's inflationary deficit financing was to raise money supply and to swell the level of aggregate demand in the economy. Inflationary borrowing in 1980 was the principal reason for the pressure on the balance of payments and the sharply expanded current account deficit caused a considerable and precipitous decline in the country's external reserves despite the vastly increased capital inflows.

Heavy and continued reliance on borrowings from non-bank sources through the issue of Rupee Loan Stock has been the main reason for the increasing share of the funded debt in the total of debt outstanding. It is useful to point out that the banking sector is now discouraged from subscribing directly to Rupee Loan Stock and subscriptions to Rupee Loan Stock are mainly from sources which are classified as institutions and persons in the non-banking sector. A significant trend noticeable in annual subscriptions to the Rupee Loan Stock is the enlargement of the captive sector as the main source of investible funds. With the amalgamation of the Post Office Savings Bank and the Ceylon Savings Bank and the centralisation of Government Savings in the National Savings Bank together with the Employee's Provident Fund and the Joint Investment Fund (on behalf of sinking funds) these institutional lenders have emerged as the principal subscribers to Rupee Loan Stock.

The share of these three sources in the total of loans floated in 1974 aggregated 83.4%. When the subscriptions of the Insurance Corporation are added the share of the captive sector in 1974 stood as high as 95%. In 1980, 97 per cent of the outstanding rupee securities were held by the Non Bank sector. Barring 1.1% subscribed by Private Provident and Pension Funds in both 1979 and 1980, the captive institutions contributed the near entirety of rupee security-issues. As in the past the Public Debt Sinking Fund, the National Savings Bank and the Employees Provident Fund continued to be the principal subscribers to Rupee Stock. The success of a government loan programme has become in these circumstances increasingly dependent on the availability of funds in these captive sources. The growing importance of the captive sector is seen in Table 7.

In examining these statistics it is important to bear in mind that an important function of the Central Bank is to obtain as wide a distribution of marketable debt as possible. It would appear that given dependence on the captive sector, the narrowness of the securities market has been a handicap in stepping up borrowings. In fact the differential rates of interest on National Savings Bank operations of borrowing from the public at 20% and 12% p.a. and investing in Government Stock at 18% on the one hand and the tax exempted interest on the funds of subscribers of 1/3 the assessable income or Rs. 2,500/- whichever is higher have been factors discouraging investors from selecting Government stock inspite of the reduced maturity period of stock from 10—12 years to 3 years and enhanced rates of interest.

The mechanism of Sinking Funds for redemption of rupee debt affords some relief for repayment yet there has been the budgetary problem of finding sufficient funds in current receipts to pay for the servicing of domestic debt. Servicing cost of domestic debt has always been regarded as a charge on current receipts. Theoretically there is no objection to financing interest charges from new loans floated. Yet very few governments have resorted to this practice. It is the growing burden of interest charges which is the mainspring of apprehension over domestic debt growth. Two points require to be underlined in this connection. Firstly, rising interest costs reduce the current account surplus and thereby reduces the volume of current receipts available for capital formation. Secondly, interest payments are in effect transfer payments and would necessitate taxation to cover payments. The redistribution of income which results is not without economic disincentives. Nor is it certain that the recipients would invest in Government Stock in view of the poor marketability of the securities.

The servicing costs of Sri Lanka's Domestic Debt has been calculated for the period 1964/65 and 1980, selected years and these are given in Table 8.

There is one other aspect of the public debt growth which remains to be examined, namely the maturity distribution of domestic debt. Rupee loans floated since 1970/71 to July 1980 carried an interest rate of 9% and 10% for a maturity period of 10—12 years. In July 1980 the interest rate on government stock was raised to 18 per cent for a shorter maturity period of 3 years. Consequently the maturity pattern of domestic debt has shifted from the long term 20—25 years distribution group to the medium term 10—15 year distribution group and would in the current situation bunch in the short end of security listings. See Table 9 for a maturity distribution of domestic debt.

Changes in maturity structure have important consequence in debt management. Firstly, they alter the structure of interest rates and secondly refunding operations are made more or less difficult depending on whether the term structure of the debt is shortened or lengthened. The maturity structure of debt can be altered at the time of new floatations. The shorter the debt, the closer it gets to the condition of money — the primary liquid asset — and consequently makes budgetary provisions more imparative and immediate.

A government with a definite long terms investment programme is normally interested in lengthening debt because long dated securities render it convenient to undetake investment projects with long gestation periods. A government can which are longer than the average lengthen debt by issuing maturities weighted maturities of outstanding debt. Influences bearing on the saleability of longer dated stock are noted as lenthening of debt involves a cost which cannot be overlooked. Sri Lankan experience of recent date is, in the light of the above observation, somewhat at cross-purposes. While government lead projects and investment programmes are long gestated, the financing of these has been from short dated funded stock and securities of unfunded, very short maturities. This makes interest and amortization heavy charges on government's payments.

In an integrated, developed economy where markets are sensitive to economic impulses, decisions are readily transmitted between product and factor markets and where in particular, monetary and fiscal measures are enforceable and have their desired effects, the structure of market rates of interest is determined by the supply and demand for securities in every sub market. The demand for securities and their transaction prices reflects market evaluation of maturity term, risk element and the liquidity attributes of each type of asset. Securities of shorter maturity, lower capital risk and which consequently embody higher liquidity carry lower rates of interest while securities which have longer maturity periods to redemption and which are exposed to higher risk of capital loss in the event of interest rate changes carry higher interest to compensate for the drawbacks.

The relationships between various short term rate and the long term rate is a complex one. Money rates of interest paid for different loans at the same date differ from one another for three main reasons. Firstly, the rates of interest vary because of differences in the length of time for which loans are to run. Secondly, because of differences in the risk of default by the borrower and thirdly because of a risk of capital loss.

The relationship between various interest rates and their maturities are explained in the liquidity theory of interest. This theory maintains, other things being equal, a person engaging in a long term contract puts himself into a more risky position than he would be, if he refrained from making it. If no extra reward is offered for a long lending most people would prefer to lend short. 'If short rates are not expected to change the long rate will exceed the short rate by a normal risk premium. If the current short rate is regarded as abnormally low, the long rate will be decidedly above it; the short rate can only exceed the long rate if the current short rate is regarded as abnormally high" (J. R. Hicks; Value & Capital p. 147). While not contesting the logical premises of the theory which are valid it should be pointed out that financial data for the United Kingdom reveal that the short term rate has often exceeded the long rate and for long periods. Whatever might be the explanation for this outcome, the facts are striking. Between 1825 and 1938, the long rate was above the short rate in 764 months and in 580 months the short rate was above the long rate. The longest time for which the short rate was without interruption above the long rate was 42 months and periods of more than 20 months were not infrequent.

To bridge theory with observable facts is often a difficult task. Yet in determining the rate of interest payable on government stock, the liquidity theory offers a practical norm for guidance. In so far as government debt is concerned, government securities are not exposed to a risk of default and therefore the considerations which influence the coupon rate on government stock are (1) risk of capital loss caused by higher interest rates in the future and (2) the premium to be offered for parting with liquidity Although a government has a built in preference for a longer dated stock in view of the nature of the investment projects financed, a higher price has to be paid for inducing subscribers to part with their funds. The higher interest payable on long dated stock has often been in conflict with government's objective of keeping as low as possible interest rates in order to minimise the servicing cost of debt. The pursuit of a policy of low interest rates artificially kept down has the disability that it makes more difficult for the government to utilise debt management as a tool for maintaining monetary stability of the economy.

Some aspects of the theory of public debt should be considered to counter the notions of a "burden" in debt growth. The growth of public debt is generally viewed with concern and almost with disfavour. Anxiety over the increase of public debt stems from a comparison of public debt with private debt. Equation of public debt with private debt has often induced false reasoning. The analogy between individual or private debt and public debt is fallacious in essential respects. A government contracting debt domestically has also the privilege of creating the means of repayment of that debt. Besides any apprehension that government might not be in a position to repay debt is ill-founded. Repayment of past debts can be effected either through direct money creation (the issue of Treasury Bills to the Central Bank) or through the floatation of new loans. It is also possible, though not often resorted to, for a government to service its debt, interest charges due on domestic debt through new loans. The private individual contracting debt does not have the same means of repaying the debt.

There are three theoretical underpinnings on which current public debt theory is supported. These may be listed as follows—

(1) The analogy between individual or private debt is fallacious in all essential respects.

(2) The creation of public domestic debt does not involve any transfer of the primary real burden to future generations.

(3) There is a sharp and important distinction between an internal and external debt.

The necessity for drawing a firm distinction between private and public debt is seen with respect to production, employment and income effects of borrowing. The public sector (the government) as well as private sector (individuals) both strive to maximise their income. But this end can frequently be missed by the public economy, if it applies the financial principles appropriate for the private economy. To an individual it is important that his expenditure be kept below or within limits of his current disposable income. For the public economy however, an increase of expenditures may frequently increase total national income and improve the fiscal position of the state. An individual is concerned exclusively with the effect of his action upon his own business. The effect of his own economic activity upon other individuals is significant only in so far as these have a bearing on his balance sheet. The balance sheet reveals to an individual all that is required to judge the appropriateness of different lines of business policy. In the case of public finance and public economy, however, it is quite otherwise. The success or failure of public policy cannot be solely read from the balance sheet of the nation. The success or failure of public policy can be determined only by noting the effect of expenditure, taxes and loans on the growth of national income, the fuller use of factors of production and how the resulting national income is distributed.

Leaving aside the consideration of an actual use to which real resources are put, also the social productivity and the time pattern of the flow of benefits from investments undertaken by the government out of borrowings, it can be stated that an act of government borrowing transfers current purchasing power from the private sector to itself. Monetary resources whether borrowed, obtained through taxes or through an increase in money supply enable the government to bid for and employ real resources in the same general time period as that in which the borrowing operation occurs. Where real resources are drawn from private employment, the full opportunity cost, that is the real cost of public expenditure is held to be borne by individuals living in the initial or current time period. Depending on the gestation lags of investment undertaken, the flow of real income takes place in a future period with the result that the current generation is called upon to sacrifice present consumption for future growth.

The precise extent of reduction in consumption is governed by the time pattern of investment outlays and the flow of services resulting therefrom. The financing of public expenditure by borrowing has close similarities to financing expenditure through taxation. In both instances the real burden of the sacrifice in consumption is borne currently. The loan method of financing as compared to the tax method involves different effects on individuals living in time periods following that of debt creation. Debt issues leave future generations with a heritage of both claims and obligations. But these claims and obligations in an internally held debt cannot constitute a burden to the community taken as a whole because they cancel each other. Future generations are no doubt obliged to pay sufficient taxes to service the debt. But the revenues collected by way of taxes are returned to the same generation though perhaps not to the same parties in the form of interest payments. Taxes are levied on income flows out of an enlarged capital stock created through abstinence in the past. As the transfer of income within the community by way of taxes is made as interest income to bond holders, it is tenable that there is no real sacrifice of resources involved in this exercise, more so if tax payers happen to be bond holders as well.

The case against public borrowing has also been expressed in terms of higher productivity of private business expenditures and its corollary that public investment is in more than one sense unproductive. To lend credibility to this thesis public debt has been classified into three types; (a) 'dead weight' debt (b) 'passive' debt and (c) 'active' debt.

Dead weight debt is one which is incurred in consequence of expenditure which in no way increases the productive power or potential of the community. These outlays yield neither an increase in revenues nor a flow of utilities which is commensurate with the amount of real resources utilised in debt creation. The most conspicuous type of public debt of the dead weight kind is that arising from war expenditure. Passive debt is one incurred from expenditures which while yielding utilities or enjoyment to the community such as public buildings, public parks and the like, neither return a money income themselves nor increase the efficiency in use of resources or productivity of labour and capital in a manner to justify the initial use of resources.

An active public debt is one incurred in consequences of (a) capital expenditures on projects which are self-liquidating and (b) expenditures directed to capital formation and economic growth which directly or indirectly increase the productive capacity of the community, enhance the flow of goods and services and enable the economy to grow at a rate faster than before borrowing was undertaken. Expenditures on public health, housing, education are designed to raise the efficiency of the people while expenditures on direct capital formation and on the conservation, improvement and exploitation of natural resources are designed to increase overall productivity and step up the tempo of capital formation.

The view that public investment is 'unproductive' while private investment is 'productive' is a very one-sided one. Public investment just as private investment may be merely utility creating or it may be efficiency creating. Public investment like private investment if wisely undertaken will be utility creating or both utility creating and efficiency promoting. There is another aspect of outlays tend concurrently to expand income and employment as well. This public expenditudes namely that it is income creating as wel in that these is particularly so in the case of public investment activity undertaken in a period when economic activity is greatly reduced. Deficit financing through debt creation for purposes of income creation may be a permanent and necessary feature in the modern public economy. The size of the public debt is of relatively little concern from the standpoint of the public economy. What is material is the manner of deployment of resources which government has absorbed and that is the productivity of investment undertaken. The assets created through (passive and active debt) match the value of the liability represented by the debt at any chosen point of time. These observations tend to show that the the notion of a burden of debt arising out of internal borrowing is misleading perhaps even a simplification. Whether in fact there is a burden depends upon the character of the expenditure for which is debt incurred and there should be justification for expenditures in terms of benefits i.e. (a) employment and income creating (b) utility creating (c) efficiency creating or some combination of these. The character of investment expenditure undertaken will effect the standard of living, the rate of growth of national product and the income (savings) available for repayment of debt. The corollary of this conclusion is that a repayment of debt by government (i.e. reduction of public debt) should come by way of a higher real product and larger flows of goods and services for private use.

Where an external debt is created the classical idea of a burden imposed on the future generation is fully applicable. The primary real burden can be shifted forward in time since there need be no domestic sacrifice of resources during the period of debt creation. The payment of interest represents a real burden when foreign debt is contracted because the domestic income stream is reduced by the necessity of transferring resources abroad. Current as well as future generations will find their incomes reduced by such transfers unless investment undertaken has augmented the real product. Finally, when a foreign debt has to be repaid, domestic resources have to be transferred to foreigners. Thus where foreign debt is contracted with extended grace period, the real burden of repayment is borne by future generation. Where there is no grace period the present generation too, is called upon to bear a part of the transfer burden. Where government expenditures have been directed to unproductive channels and such expenditures are financed through external debt creation, the growth of external public debt may be regarded as acts of financial irresponsibility resulting in a financing burden on current and future generations.

There is one last observation to be made in the theoretical underpinnings of public debt theory, namely, that borrowing is only one of the means through which a government secures monetary resources for absorbing real resources. Except in the case of anti-inflationary debt issues for monetary management public borrowing involves the transfer of real resources. Borrowing is therefore, an alternative to taxation. If a given level of public expenditure is to be financed this can be accomplished in three ways: (1) taxes (2) loans and (3) credit (currency) creation. It is necessary to examine the problem of financing national expenditures in terms of the whole set of fiscal alternatives and the effects of debt creation should be analysed in differential terms. If debt is not to be issued and borrowing is to be contained then taxes have to be increased, alternatively credit creation should take place or there should be a reduction in the level of public expenditures or a mix of these alternatives.

Of the securities offered in the domestic market, rupee loan stock issues constitute the most important item in value terms of the internal debt of the country. But the absorption of rupee loan stock by private individuals and non-captive sources has been most disappointing, notwithstanding the higher rate of return and lower maturity. In fact, there hardly exists a market for these securities out side the the captive sector. Support for government loan stock has come principally from funds arising in the captive sector. There are several explanations which can be advanced for the poor response from private individuals and non-government institutions.

Firstly, the yield differential between government loan stock and interest rates paid on financial investment offered by National Savings Bank, Commercial Banks, hire purchase companies, financial companies and other private sector financial institutions has tended to widen, with the latter group offering appreciably higher interest rates on borrowed funds. These higher rates of interest may have lured investible funds from the government securities market. With the recent legislation of registration of finance companies with the Central Bank and the supervision of these operations by officials of the Bank Supervision Department, the investor could look forward to a more disciplined monetary structure. The risks of defaults being reduced the individual investor as well as the corporate investor would patronise these institutions, leaving the government stock issues to captive sources.

Secondly, government stock is despite shorter maturities offered relatively 'illiquid.' The Central Bank (Dept. of Public Debt) though willing to support the market and as is ready to prevent disorderly movements in market value so as to support investor confidence, nevertheless mediates only in respect of securities offered by small investors, trusts and charitable institutions. Central Bank purchases at the official valuation are thus restricted and transactions have in general to go through brokers. Besides there is very little trading which takes place even at market valuations. Institutional investors in the captive market are inclined only to support new issues and their purchase of stock in the open market is negligible. Thus subscribers are often faced without buyers and find themselves 'locked-in' with their investments.

Thirdly, the attractiveness of government securities as an investment outlet has greatly diminished because of the inflationary situation which has developed. It is during periods of stable or falling prices (i.e. the general level of prices) that investors show a preference for securities with a fixed rate of return. Under inflationary conditions investor preferences shift from bonds to capital appreciating assets, equities, bullion and real estate.

Fourthly, the poor response for government securities from private investors could well be the outcome of a divergence of preferences of investors and the needs of government and its financial commitments. The preference of government has has been till recently to float long terms loans so that funds raised may be directed to investment projects with long gestation lags. The terms of the loan and the returns from investment can be synchronised where long stocks are issued as to enable the loan to be repaid from the returns from investment. Besides the above, a long term debt structure renders debt management as easy task. However, given expectations of increases in interest rates and the use of higher interest rates to curb investment activity and monetary demand, investors are reluctant to tie up funds for long periods. Investor preference is for short dated stock as (1) they prefer to be more liquid in the situation of inflationary price increases (2) the market value of short dated stock is relatively more stable and (3) the risk of capital loss on short dated securities is comparatively small. There is then a conflict between government's financing terms and what the public is willing to absorb.

Fifthly, it is conceivable that taxation and fiscal policy may have also restricted the expansion of the government securities market as a possible outlet for private sector funds. High taxation of income is generally acknowledged to have encouraged widespread tax evasion. Those who have evaded taxes are not likely to deposit their earnings either in banks or in securities which may be scrutinised by tax authorities. The popularity of Certificates of Deposits as a investment outlet for 'Black Money' is evidence which supports this observation.

In the same context it should be mentioned that rules and regulations for administering debt which bear on the mode of payments of interest on government rupee stock, the requirements insisted as regards endorsement of securities before ownership of securities is transferred and the time lags that ensue between receipt of interest vouchers by stockholders and the actual receipt of interest, the streamling which is necessary to develop and foster the keenness of investors as subscribers to stock, may have militated against the development of a wider government securities market. Especially as these regulations have had the unintended effect of reducing the marketability of these investments.

The borrowings of the government in any one year are determined primarily by budgetary requirements. The volume of debt contracted and the maturity pattern of debt issued, however, influence the state of liquidity in the money market, as well in a round about way, the supply of loanable funds. Thus, it is an important task of the Central Bank to advice government on the feasible amounts of new loans to be floated and on the terms and timing of offering of these to the investing public. A loan programme has to take into account compulsory repayments falling due on maturity. If these repayments add up to a large amount, government may experience in the absence of Sinking Funds or ready subscribers for conversion loans — a temporary difficulty in meeting both the loan programme and raising of sufficient cash to meet cash conversions. A bunching of repayments (where conversion is not possible) coupled with a large domestic loan programme could bring about a temporary cash shortage. However, with captive markets to lend support and with repayment proceeds of maturing debts accruing to these sources such temporary difficulties are unlikely impair confidence in government's ability to repay. Besides through conversion operations (refunding) the extent of cash payments to be made can be minimised.

Nevertheless, to obviate even temporary difficulties of cash, the maturity pattern of debt should be so arranged that as far as possible these would not hamper regular market borrowings. For purposes of ascertaining the bunching of debt payments, a maturity distribution of debt has been presented in table 10.

The above frequency distribution reveals that the repayments are evenly distributed with amount falling due for payment of roughly equal amount, baring 1984. However, the adoption of short maturity for the current borrowing programme would tend to increase the nominal amounts in respect of what Sinking Funds have been provided. In effect the "conversion" which takes place by reinvestment of sinking fund monies amounts to a postponement of the debt for a further term equivalent to the latest date of maturity.

A study of Sri Lanka's external debt growth should focus on the Balance of Payments effects of external stocks and the modes of adjustment. For a large number of countries the adjustment to oil prices was crucially painful. Governments of oil importing countries had not only to aim at balance of payments adjustments but also to choose investment and production priorities so as to reduce the shocks of loss of growth.

The large and continuing external payments deficits and the inadequacy of our external resources to finance them has necessitated the placing of heavy reliance on foreign credits to tide over difficulties. This mode of financial accommodation resulted in the mid seventies in external liabilities increasing very sharply and concomitantly registering an increase in the service payments on foreign debt. As will be shown, the position has improved markedly in more recent years especially since 1978.

Service payments on foreign debt which absorbed 22% (1970-73) currently absorb on average about 14 per cent of the country's foreign exchange earnings in rupee terms as seen in the data given in Table 11.

The debt service ratio is the proportion of foreign exchange earnings on current account absored by external debt. A rising ratio indicates an increasing burden and a falling ratio signifies the opposite effect. Sri Lanka's debt ratio, shows an improvement which is most welcome. The ratio has fallen from 23% in 1973 to 12.4% in 1980.

Both amortisation and interest payments have shown in the early seventies sharp increases. The higher rate of increase of interest payment is the outcome of both the higher level of borrowings effected and the increasing reliance on short term credits and commercial borrowings which carry higher borrowing rates. There has been a gradual shift in the period since 1977 from suppliers credits to institutional borrowings. The fall in the debt service ration is both the result of higher export earnings and the greater recourse to short term acceptance credits which do not figure in debt service ratio calculations.

International comparisons of debt service ratios have many pitfalls. Debt service ratios are based on debt service actually paid and not on contractual debt due. If a country had defaulted on debt this would be reflected in a lower debt ratio than if contractual debt had been used. It is necessary to point out that the debt service ratio is per se an incomplete indicator of a country's debt situation. Many other factors have a bearing on debt servicing capacity. Among these the stability and diversification of the country's export structure, the prospects for future growth and development efforts undertaken, the extent of import substitution undertaken, the time profile of the country's debt, the size of foreign exchange reserves, compensatory drawing facilities available are worthy of note.

Noting these, it is still possible to list countries according to relative performance in respect of debt servicing and thereby place the country in question (i.e. Sri Lanka) on an international setting. Data in Table 12 show the debt servicing record of several countries, all worked out in terms of a common external currency.

Sri Lanka's debt servicing ratios have been in general, lower than that of India and Pakistan; yet compared with a number of developing countries of similar size, natural resource utilisation, and economic development, Sri Lanka's debt servicing ratios were high in the sixties and seventies. Note that in 1965 there was only one other country which had a debt service ratio lower than Sri Lanka, namely Malaysia. In 1972 there were six countries whose debt ratios were lower than Sri Lanka. In 1978, there were three countries with lower ratios. In other words, resources absorbed for debt servicing have grown larger and the servicing cost has increased over time. It would be a relevant inference that Sri Lanka would be faced with problems of rescheduling her debt or seeking debt relief unless present trends are maintained or there are compensatory increases in export earnings to bear higher debt incidence.

Maintaining current trends will not be an easy exercise because of the heavy investment programmes undertaken, the possible growth of short term debt in the event of delays in the receipt of official assistance and bank borrowings. These items have shown increases and because the repayment of principal follows very soon in the wake of the loan commitment there is limited scope for rescheduling except at a cost.

A containment of the growth in Sri Lanka's foreign debt service payment should begin by a reduced reliance on commercial borrowings. It is not necessary to interpret fully the data in Table 13 as the statistics are self explanatory. In the period 1969 to 1972, suppliers credits showed a steep increase and their servicing costs exceed the servicing costs of DAC loans even though in volume terms the loans from DAC group were nearly 4 times larger. Note also that repayment of principal on suppliers credit accounted for a disproportionately high share and nearly equalled the total of interest and repayment of principal on loans from DAC countries. Reliance on short term credit imposed a severe strain on the debt servicing obligations of the country. In the period 1977 to 1979 even following a much increased volume of borrowing, the weight of service payments (principal and interest) in debt outstanding showed a favourable downward trend. The latter result was principally due to the greatly reduced reliance on suppliers credit and the greatly increased dependence on international organisations and DAC assistance.

Although Sri Lanka had consciously reduced her reliance on costly commercial credits, the burden of foreign debt financing of loans already disbursed is likely, in the future, to be a problem of some magnitude. With a view to quantifying same, estimated debt service payments on debt outstanding as at end of year 1980 is given for years 1981 to 1986.

The burden of external debt servicing would apparently be most severe in the years 1985 and 1986 with

		Million US $				
	1981	1982	1983	1984	1985	1986
1. Total Debt Service	94.2	95.5	102.1	111.0	115.1	112.3
2. Of which principal payment	60.1	59.0	64.8	75.9	83.1	83.5
3. Amount of Principal due to official lending	47.1	48.5	43.3	54.8	63.9	65.5

Source: E 167/80

payments totalling US$ 115.1 million and US$ 112.3 million respectively falling due. These figures would alter as more foreign debt is contracted and utilised and repayment obligations are increased. A growing foreign debt inescapably underlines the central proposition that foreign debt repayment should come from real resources and export surpluses.

The scope for rescheduling debt in the event of a catastrophic fall in export receipts or a totally unforseen adverse import programme is yet promising as the share of official borrowing is higher than that from private and commercial sources. However, the actual relief that would be forthcoming would depend on the nature of fiscal and monetary policies pursued in correcting the "manageable" items of the balance of payments deficit as well as creditor confidence on the structural adjustment package accepted by Sri Lanka. Whatever be the scenario, whether it is a high forecast or otherwise, the safest course when embarking upon a foreign debt financed programme of investment would be for the government concerned to undertake additional domestic resource mobilisation, increase such efforts and constantly keep in review the size and scope of the investment programme. In such a context, donors too would be agreeable to offer concessional terms as well as be willing to reschedule debt.

Sri Lanka has a good claim on figures studied here to request from lending countries more favourable terms for borrowing emphasising that as her economy's productive capacity gets enhanced the servicing of past debts could be achieved without undue strain on domestic consumption and real incomes of the people. The present foreign debt servicing ratios are modest in relation to export earnings. A fall in the ratio is seen for 1980 on account of higher rupee earnings of exports. For the servicing problem to be manageable, continuing gains on the export front will have to be buttressed by more judicious use of funds borrowed. Better borrowing terms on the plea of productive use of resources and a higher repayment potential stemming from an enlarged viable economy wil also help to lower the debt servicing ratio facing the country.

The formidable challenge before Sri Lanka is that of maintaining — within the constraints of resources available for development financing and the chosen time horizon for repaying these benefits — the now firmly committed accelerated and heavy capital intensive investment programme begun in 1977. The sacrifices to be made to achieve the growth objectives — as planned within the confines of the time horizon chosen — are many and hard. Nor for that matter is the path of adjustment to achieve these goals clearly defined or easily contoured. Among the sacrifices, one should reckon even a possibly lowered prospect for employment and economic growth in the short-medium term, if the mechanics of demand management necessitate a cutting back on the level of investment because of a lack of foreign assistance or domestic fiscal and monetary mismanagement and even

TABLE 1 INDICATORS OF PUBLIC DEBT GROWTH 1959-64, 1970-74 & 1975-80

Total Net Public Debt and Gross Domestic Product at Current Factor Cost Prices

Rs. Million

PEROD I	1959	1960	1961	1962	1963	1964	Av.
1. G.D.P.+	5930	6331	6353	6549	6849	7326	6556
2. Total Net Public Debt	1524.7	1912.8	2332.7	2688.9	3065.4	3436.0	2493.4
3. 2% 1 Weight of Debt ...	25.8	30.3	36.7	41.1	44.8	46.9	38.0

PERIOD II ...	1970	1971	1972*	'73 Dec.	'74 Dec.	Av.
1. G.D.P. ...	13,187	13,674	14,720	17.920	23,302	16,561.0
2. Total Net Public Debt	7,236.8	8,108.0	9,448.3	10,280.8	11,026.9	9,220.2
3. 2% 1 Weight of Debt	54.9	59.3	64.2	57.4	47.3	55.7

PERIOD III	'75 Dec.	'76 Dec.	'77 Dec.	'78 Dec.	'79 Dec.	'80 Dec.−	Av
1. G.D.P.	25,691	28,032	34,684	40,479	49,782	62,246	40,152
2. Total Net Public Debt	12,959.7	15,620.7	22,434.1	27,745.7	31,511.8	46,779.0	26,172.2
3. 2% 1 Weight of Debt	50.4	55.7	64.7	68.5	63.3	75.2	65.2

Notes:

+ G.D.P. data are on a calendar year basis. Public Debt data for all years upto 1970–71 relate to financial year ending 30th September. Data for 1971–72 relate to a 15 month period, October 1971 to December 1972. The fiscal year coincides with the calendar year with effect from 1973.

* 15 month period.

+ Provisional

Source: *Central Bank of Ceylon (Annual Reports)* labour unrest reacting to a continuing inflationary situation. Loss of investor confidence for whatever reason and reduced international credit standing are also likely to arise if timely adjustments and sacrifices are not made to curtail unwarranted, conspicuous consumption, the widening merchandise trade deficits and a re-aligmament of possibly ambitious and mis-matched investment priorities. To survive these strains, more attention would have to be given to a better use of externally borrowed funds, cutting down on waste and the gearing or matching of investments to time profiles of output responses which help to augment aggregate supply for better management.

The key elements in the exercise of meeting challenges and sacrifices would be to map out a medium term strategy consistent with the use of available and readily reckonable external borrowings without endangering external stability. The alternative would be a painfully sharp currency devaluation to maintain relative export competitiveness.

An adjustment of public and corporate investment away from highly capital intensive programmes with built in high import content to favour quick gestating projects benefiting wider productive sectors (i.e. not merely trading banking and service sectors) would be opportune. So, too, would be the conscious development of fiscal and monetary intervention instruments and infrastructural institutional developments such as a stock exchange, a merchant banking network, variable reserve ratios for commercial banks and reasonable net advances to deposit liquidity ratios which would help to mobilise more effectively domestic resources out of incremental incomes and channel these to productive activity. Re-investment activities financed from income absorption from the current income streams would enable investments to be financed from sources with a lower potential for monetary expansion as against direct credit creation. The sacrifices on the one hand made from restraining present consumption and the lowered employment and income targets arising from a modest growth rate and slightly lower waiting period and on the other hand, a restrain in the use of foreign commercial borrowings by a careful husbanding of foreign resources which infringe less severely or the servicing costs of loans would not be too costly a price to pay, when viewed against the alternatives of political choice open to the country and a jettisoning of current forward looking policies.

TABLE 2 COMPARATIVE POSITION OF NET BORROWING IN FINANCING BUDGETARY OUTLAYS, FINANCIAL YEARS 1954-55 to 1958-59, 1964-65 to 1974 and 1977 to 1981

Rs. Million

			(1) *Total 1/ payments*	(2) *Total current receipts*	(3) *Gap 1-2*	(4) *Direct 2/ borrowing*	(5) *4%3 Amt. covered by direct borrowing*
1954–55	...	...	1,068.1	1,241.4	+172.3	35.1	(19.68)
1955–56	...	...	1,322.7	1,256.0	66.7	190.3	284.9
1956–57	...	...	1,506.0	1,273.0	-233.0	189.0	81.12
1957–58	...	...	1,553.3	1,312.4	-240.9	344.8	143.13
1958–59	...	...	1,783.2	1,398.8	-384.4	423.1	110.07
1964–65	...	...	2,431.8	1,968.0	-463.8	386.8	83.40
1965–66	...	...	2,609.0	2,011.1	597.9	606.9	101.51
1966–67	...	...	2,824.6	2,179.7	-644.9	609.9	94.57
1967–68	...	...	3,152.6	2,404.1	-748.5	722.8	96.57
1968–69	...	...	3,578.1	2,752.0	-826.1	656.9	79.52
1969–70	...	...	3,915.1	2,924.8	-990.3	898.4	90.72
1970–71	...	...	3,973.8	2,835.8	-1,138.0	900.3	79.11
1971–72	...	...	5,403.8	4,032.1	-1,371.7	1,364.1	99.45
1973	...	...	5,026.6	3,928.6	-1,098.0	882.6	80.38
1974	...	...	5,829.5	4,682.7	-1,146.8	743.7	64.85
1977	...	...	8,812.8	6,543.7	-2,269.1	2,117.6	93.32
1978	...	...	17,687.7	11,473.5	-6,214.2	5,281.6	85.00
1979	...	...	20,339.3	12,474.7	7,864.6	6,246.5	79.42
1980+	...	...	28,532.3	13,914.7	14,617.6	12,224.1	83.63
1981++	...	...	26,226.7	15,322.8	-10,903.9	10,230.0	93.82

Notes

1/ Total payments include Current Payments (Purchase of goods and services plus Transfers) Capital Payments (Acquisition, construction and maintenance of real assets, Transfers and acquisition of financial assets and Net payments on account of operation.

2/ Direct Borrowing includes borrowing from Central Bank, Commercial Banks, Private non-Banks, non market borrowings and Foreign borrowings and excludes grants and capital transfers from abroad.

+ Provisional.

++ Estimated.

Source: *Central Bank of Ceylon.*

TABLE 3 SOURCE OF FINANCING CAPITAL EXPENDITURE FINANCIAL YEARS 1955-56 TO 1959-60, 1964-65 TO 1974 AND 1977 TO 1981

Rs. Million

			(1)	(2)	(3)	(4)	(5)
			Capital 1/ Expenditure	*Source of 2/ finance Current A/C Surplus (+) Deficit (—) as % of Total capital expenditure.*	*Borrowings abroad Grants & Capital transfers as% of capital expenditure*	*Net domestic borrowing as % of capital expenditure*	*(3+4)3/ Total borrowing as% of capital expenditure*
1955/56	...	...	430.9	91.5	6.6	6.7	13.3
1956–57	...	...	395.9	70.5	6.5	44.3	50.8
1957/58	...	...	498.6	31.0	6.7	33.8	40.5
1958/59	...	...	493.0	7.7	9.7	63.9	73.6
1959/60	...	...	495.7	4.7	6.7	80.6	87.3
1964/65	...	...	536.7	14.7	18.6	58.0	76.6
1965/66	...	...	596.7	3.6	19.7	88.9	108.9
1966/67	..	...	698.7	12.4	29.9	60.2	90.1
1967/68	...	...	789.2	1.9	24.0	70.9	94.9
1968/69	...	...	909.8	15.3	38.7	35.4	74.1
1969/70	...	...	883.1	11.4	25.6	83.2	108.8
1970/71	...	...	789.6	–32.2	29.3	90.8	120.1
1971/72	...	...	1,140.2	–4.6	31.1	95.0	126.1
1973	...	...	1,160.8	12.8	13.8	65.3	79.1
1974	...	...	1,244.9	8.6	30.4	49.6	80.0
1977	...	...	2,193.8	–0.4	57.2	62.1	119.3
1978	...	...	5,424.1	17.6	72.9	36.7	109.6
1979	...	...	7,729.4	11.5	48.3	50.4	98.7
1980 +	...	...	11,757.1	3.2	52.1	74.0	126.1
1981 +	...	...	11,015.7	–1.0	68.4	24.4	92.8

Notes:

1/ Capital expenditure data given here include capital items in recurrent votes and projects but exclude current elements in capital votes and projects.

2/ Current account surplus or deficit (–) is the excess or shortfall of current receipts over current payments.

3/ The figures where these exceed 100% are reflected as increases in cash balances.

+ Provisional.

Source: *Central Bank of Ceylon.*

TABLE 4 RELATIVE SHARES OF TAXES AND BORROWING IN COVERING PAYMENTS 1955/56 TO 1959/60, 1964/65 TO 1974 & 1977 TO 1981

Rs. million

		(1) *Total payments*	(2) *Total taxes* 1/	(3) *Total Direct Borrowing*	(4) 2% 1 *Tax share*	(5) 3% 1 *Borrowing share*	(6) 3% 2
1955/56	...	1,322.7	1,015.5	34.1	76.77	2.58	3.36
1956/57	...	1,506.0	1,011.7	190.5	67.18	12.64	18.81
1957/58	...	1,553.3	1,016.6	174.7	65.44	11.25	17.18
1958/59	...	1,773.3	1,057.5	351.8	59.63	19.84	33.27
1959/60	...	1,821.3	1,119.5	423.4	61.47	23.25	37.82
1964/65	...	2,431.8	1,439.9	386.8	59.21	15.91	26.86
1965/66	...	2,609.0	1,400.0	606.9	53.66	23.26	43.35
1966/67	...	2,824.6	1,401.3	609.9	49.61	21.59	43.52
1967/68	...	3,152.6	1,682.4	722.8	53.37	22.93	42.96
1968/69	...	3,578.1	1,981.5	656.9	55.37	18.36	33.15
1969/70	...	3,915.1	2,260.1	898.4	57.73	22.95	39.75
1970/71	...	3,973.8	2,276.5	900.3	57.29	22.66	39.55
1971/72	...	5,403.3	3,284.7	1,364.1	60.79	25.25	41.53
1973	...	5,026.6	3,309.2	882.6	65.83	17.56	26.67
1974	...	5,829.5	4,020.8	743.7	68.97	12.76	18.50
1977	...	8,812.8	5,508.6	2,117.6	62.51	24.03	38.44
1978	...	17,687.7	10,382.3	5,281.6	58.70	29.86	50.87
1979	...	20,339.3	11,154.8	6,246.5	54.84	30.71	56.00
1980	...	28,532.3	12,506.9	12,224.1	43.83	42.84	97.74
1981 †	...	26,226.7	13,785.3	10,230.0	52.56	39.01	74.21

Notes:

1/ Total taxes include personal taxes plus taxes on corporate income plus taxes on production and expenditure plus death duties plus other capital taxes minus profits from food sales.

† Provisional.

Source: *Central Bank of Ceylon Annual Report.*

TABLE 5 TOTAL PUBLIC DEBT–1968/69 TO 1974 (a) (Financial Years) 1977 TO 1980

As at end of Financial Year		1968/69 *Amount Rs. Mn.*	%	1969/70 *Amount Rs. Mn.*	%	1970/71 *Amount Rs. Mn.*	%	1971/72 *Amount Rs. Mn.*	%	1972/73 *Amount Rs. Mn.*	%	1974 *Amount Rs. Mn.*	%
1. **Gross Debt**	...	6,888.5	100.0	7,873.2	100.0	8,782.8	100.0	10,318.7	100.0	11,379.9	100.0	12,380.1	100.0
1.1 Foreign	...	1,375.5	20.0	1,578.4	20.1	1,800.1	20.5	2,392.5	23.2	2,795.3	24.6	2,973.7	24.0
1.2 Domestic	...	5,513.0	80.0	6,294.8	79.9	6,982.2	79.5	7,926.2	76.8	8,584.6	75.4	9,406.4	76.0
2. **Net Debt (b)**	...	6,239.9	100.0	7,236.8	100.0	8,108.0	100.0	9,448.3	100.0	10,280.8	100.0	11,036.9	100.0
2.1 Foreign	...	1,337.3	21.4	1,550.9	21.4	1,767.6	21.8	2,352.5	24.9	2,750.5	26.8	2,931.5	26.5
2.2 Domestic	...	4,901.6	78.6	5,685.9	78.6	6,340.4	78.2	7,095.8	75.1	7,530.3	73.2	8,105.4	73.5

As at end of Financial Year				1977 *Amount Rs. Mn.*	%	1978 *Amount Rs. Mn.*	%	1979 *Amount Rs. Mn.*	%	1980 *Amount Rs. Mn.*	%
1. **Gross Debt**	...	...	...	25,985.9	100.0	20,949.8	100.0	35,474.7	100.0	51,655.6	100.0
1.1 Foreign	...	...	...	10,593.5	42.4	14,582.3	47.1	15,840.6	44.7	22,276.8	43.1
1.2 Domestic	...	...	...	14,392.4	57.6	16,367.6	52.9	19,963.4	55.3	29,378.8	56.9
2. **Net Debt**	...	...	...	22,434.1	100.0	27,745.7	100.0	31,511.8	100.0	46,779.0	100.0
2.1 Foreign	...	...	...	10,593.5	47.2	14,582.3	52.3	15,840.6	50.3	22,276.8	47.6
2.2 Domestic	...	...	...	11,840.6	52.8	13,163.4	47.7	15,671.2	49.7	24,502.2	52.4

Notes: (a) Excluding (i) National Housing and State Mortgage Bank debentures (ii) Debt on account of imports of government departments under suppliers, credit and (iii) Promissory notes issued in favour of international financial organisations).

(b) Gross debt less sinking funds in respect of sterling and rupee loans. Commencing 1975 there is no liability on transfers of sterling loans and hence net and gross foreign debt is the same.

Source: *Central Bank of Ceylon Annual Reports.*

TABLE 6 COMPOSITION OF DOMESTIC PUBLIC DEBT AND CHANGES 1968/69 TO 1974 AND 1977-1980

Rs. million

		Rupee Loans Gross	Rupee Loans Sinking Funds (a)	Rupee Loans Net	Treasury Bills	Tax Reserve Certificates	Central Bank Advances	National Development Bonds & others	Total Gross	Total Net
1 Sept.	1969	3,409.1	611.4	2,797.7	1,750.0	24.5	329.3	0.1	5,513.0	4,901.6
,,	1970	3,924.9	608.9	3,316.0	1,950.0	45.4	374.4	0.1	6,294.8	5,685.9
,,	1971	4,511.9	642.2	3,869.6	2,025.0	66.0	379.	0.2	6,982.6	6,340.4
31 Dec.	1972(b)	5,103.0	830.4	4,273.0	2,325.0	78.0	419.6	0.2	7,926.2	7,095.3
,,	1973	5,812.2	1,054.3	4,757.9	2,250.0	66.1	456.1	0.2	8,584.6	7,530.4
,,	1974	6,590.5	1,301.0	5,289.5	2,250.0	67.9	497.9	37.9	9,444.2	8,143.2
31 Dec.	1977	10,391.6	2,551.8	7,839.8	2,500.0	40.6	617.4	842.8	14,392.4	11,840.6
	78	12,049.1	3,204.1	8,845.0	2,635.0	29.5	955.5	698.5	16,367.5	13,163.4
	79	14,929.1	3,962.9	10,966.2	3,000.0	28.0	1,136.5	540.6	19,634.1	15,671.2
	80	17,611.0	4,876.6	12,734.4	9,800.0	12.5	1,627.6	327.7	29,378.8	24,502.2
Change	1970/69	+515.8	—2.5	+518.3	+200.0	+20.9	+45.1	—	+781.8	+784.3
Change	1971/70	+587.0	+33.3	+553.6	+75.0	+20.6	+5.1	+0.1	+68.8	+654.5
Change	1972 Dec./'71 Sept. ...	+591.3	+188.2	+403.4	+300.0	+12.0	+40.1	—	+943.6	+755.4
Change	1973	+708.8	+223.9	+484.9	-75.0	—11.9	+36.5	—	+658.4	—434.5
Change	1974	+778.3	+246.7	+531.6	—	+1.8	+41.8	—0.1	+821.8	+575.1
Change	78	+1,657.5	+652.3	+1005.2	+135.0	-11.1	+338.1	—144.3	+1975.1	+1322.8
Change	79	+2,880.0	+758.8	+2121.2	+365.0	1.5	+181.0	—157.9	+3266.6	+2507.8
Change	80	+2,681.9	+913.7	+1768.2	+6800.0	15.5	+491.1	—212.9	+9744.7	+8831.0

(a) Representing the market value of investments held on behalf of sinking funds (including supplementary Sinking funds).

(b) Including special loans towards payment of membership subscriptions to the IMF, the IBRD, the IDA and the ADB. Net of loans which amounted to Rs. 98.5 million at the end of December 1974, the Central Bank advances increased by Rs. 29.1 million in 1974. These special loans exclude promissory notes issued in favour of international financial organisations.

Source: *Central Bank of Ceylon.*

TABLE 7 CLASSIFICATION OF SUBSCRIPTIONS TO RUPEE SECURITIES (a)

Subscribers	1968/69 Amount Rs. Mn.	1968/69 Percentage	1969/70 Amount Rs. Mn.	1969/70 Percentage	1970/71 Amount Rs. Mn.	1970/71 Percentage	1977 Amount Rs. Mn.	1977 Percentage	1979 Amount Rs. Mn.	1979 Percentage	1980 (Provisional) Amount Rs. Mn.	1980 (Provisional) Percentage
1. Bank Sector ...	0.6	0.2	117.5	20.3	12.7	1.9	—	—	—	—		—
1.1 Commercial Banks ...	0.6	0.2	117.5	20.3	12.7	1.9	...					—
2. Non-Bank Sector ...	339.4	99.8	461.7	79.7	668.1	98.1	1500.0	100.0	2950.0	100.0	2801.5	100.0
2.1 Savings Inst. (b) ...	36.9	10.6	156.1	26.9	216.0	31.7	402.1	26.8	1128.7	38.3	918.1	32.8
2.2 Sinking Funds ...	111.8	32.9	83.0	14.3	161.8	23.8	506.8	33.8	771.3	26.1	817.6	29.2
2.3 Departmental & other official funds ...	8.4	2.5	6.2	1.1	9.4	1.4	1.7	0.1	0.1	...	—	—
2.4 Employees' Prov. Fund.	101.3	29.8	97.9	16.9	143.0	21.0	397.1	26.5	835.9	28.4	900.7	32.1
2.5 Insurance Corp. ...	42.5	12.5	45.5	7.9	60.8	8.9	120.3	8.0	182.5	6.1	135.5	4.8
2.6 Private Prov. & Pension Funds ...	36.8	10.8	53.9	9.3	62.1	9.1	70.0	4.7	31.5	1.1	29.6	1.1
2.7 Insurance Corp. ...	0.6	0.2	16.1	2.8	6.3	0.9	0.3	...	—	—	—	—
2.8 Others Cos. ...	0.2	0.1	0.6	0.1	0.8	0.1	...	...	—	—	—	—
2.9 Individuals Clubs & Institutions ...	1.5	0.4	2.5	0.4	7.9	1.2	1.7	0.1	...	...	—	
3. Total ...	340.0	100.0	579.2	100.0	680.9	100.0	1500.0	100.0	2950.0	100.0	2801.5	100.0

(a) Refers to rupee loans only.

(b) With effect from 1st April 1972, the National Savings Bank has taken over the assets and liabilities of the Post Office Savings Bank, Ceylon Savings Bank and the Savings Certificates Fund.

TABLE 8 INTEREST ON DOMESTIC DEBT 1964-1980—SRI LANKA

Rupees million.

	Total current expenditure	*Interest on domestic debt*	*Of which interest on Rupee Loan*	2% 1
1964/65	1895.8	87.4	73.6	4.6
1965/66	1996.8	103.2	85.4	5.2
1966/67	2096.7	118.4	100.1	5.6
1970/71	3096.7	263.4	195.7	8.5
1971/72	4084.8	401.0	309.5	9.8
1973	3790.6	392.8	319.1	10.4
1978	10,521.5	1054.7	839.0	10.0
1979	11,588.0	1276.9	1028.7	11.0
1980 (Prov.)	13,535.2	1787.4	1330.1	13.2

Source: *Central Bank of Ceylon.*

TABLE 9 DOMESTIC DEBT-ANALYSIS BY MATURITY DISTRIBUTION 1960/61 TO 1963/64, 1969/70 TO DEC. 73 AND 1978 TO 1980 (as at least date of maturity)

Financial Year	60/61	61/62	62/63	63/64	69/70	70/71	Dec. 72	Dec. 73	1978	1979	1980 (Prov.)
1. Total Domestic Debt. Rs. M.	2234.0	2693.7	3030.2	3275.3	6294.8	6982.5	7926.2	8584.6	16,367.5	19,634.2	29,378.8
2. Unfunded Debt* as % of Total	40.4	43.7	44.4	43.4	37.6	35.4	35.6	32.3	22.1	21.2	38.9
3.1 Funded Debt as % Total ...	59.6	56.3	55.6	56.6	62.4	64.6	64.4	67.7	77.9	78.8	61.1
3.2 Below 5 Yrs. % Total ...	11.6	10.1	8.1	6.1	7.8	5.7	5.4	5.0	6.4	8.1	13.4
3.3 5–10 Yrs. % Total ...	7.9	8.5	12.1	13.2	6.1	1.1	3.9	13.9	35.7	35.6	26.3
3.4 10–15 Yrs. % Total ...	9.8	6.7	7.4	6.4	8.5	19.4	28.7	26.6	29.2	32.2	20.2
3.5 15–20 Yrs. % Total ...	16.5	14.3	8.2	7.3	16.6	16.0	17.2	17.9	2.5	0.2	
3.6 20–25 Yrs. % Total ...	13.8	16.6	19.8	23.6	23.3	16.5	9.1	4.3	—	—	

Source: *Annual Report of Central Bank*

TABLE 10 MATURITY DISTRIBUTION OF RUPEE LOANS 1980-1995 BASED ON COMPULSORY DATE OF REPAYMENT

(Position as at 31st December, 1980)

No.	*Year of Maturity*	*No. of Loans*	*Total Amount Repayable*
1	1981	01	24,860,000*
2	1982	—	—
3	1983	21	2,038,111,900
4	1984	18	908,168,600
5	1985	20	1,277,278,600
6	1986	18	1,141,788,700
7	1987	18	1,172,275,300
8	1988	17	1,637,532,300
9	1989	17	1,752,417,100
10	1990	17	2,010,000,000
11	1991	24	3,307,123,100
12	1992	15	1,916,422,800
13	1993	11	350,000,0000
14	1994	11	340,000,000
15	1995	01	35,000,000
	Total	209	17,610,978,400

* Repaid on 1.2.1981

Source: *Dept. of Public Debt*
Central Bank of Ceylon.

TABLE 11 FOREIGN DEBT SERVICING RATIOS SRI LANKA 1970-1973 AND 1977-1980

Rs. million

	1970	1971	1972	1973	1977	1978	1979	1980 (Prov.)
1. Foreign debt service payments ...	451.4	491.6	480.2	629.2	1211.9	2347.2	2383.1	2762.8
a. Amortisation	351.7	387.1	378.3	520.8	2966.9	1862.4	1627.4	1781.5
b. Interest	99.7	104.5	101.9	108.4	45.0	484.0	755.7	981.3
2. Earnings on exports goods & services ...	2251.3	2244.2	2205.9	2733.3	7563.2	15148.8	18274.7	22208.0
3. Debt service ratio 1:2	20.1	21.9	21.8	23.0	16.0	15.5	13.0	12.4

Note: Values from 1971 onwards are affected by the Devaluation and subsequent floating of the rupee.

TABLE 12 INTERNATIONAL COMPARISON OF DEBT SERVICING RATIOS 1965-67, 1970-72 AND 1977-79

(Debt Service as percentage of the exports of goods & Services)

	1965	1966	1967	1970	1971	1972	1977	1978	1979
1. Sri Lanka	2.0	2.8	3.4	9.7	11.3	14.3	14.5	9.2	6.5
2. India	15.0	21.9	24.8	22.5	24.7	24.1	9.6	9.9	n.a
3. Pakistan	11.0	13.0	17.2	24.2	34.0	25.0	13.7	12.4	12.2
4. Burma	4.6	4.6	6.4	16.1	13.6	16.3	13.6	15.4	25.0
5. Indonesia	10.3	8.4	5.3	7.0	7.8	8.0	11.4	12.3	13.4
6. Malaysia	1.3	1.4	2.1	3.0	2.7	3.0	6.6	8.4	4.7
7. Thailand	3.7	3.4	3.6	3.6	3.3	2.8	10.6	15.8	13.9
8. Philippines	5.4	6.4	7.2	7.5	7.0	6.8	14.3	26.5	23.2
9. Tanzania	4.5	3.8	4.4	6.7	7.4	9.5	7.2	7.4	n.a.
10. Kenya	5.9	5.9	6.8	5.3	5.8	5.6	4.8	8.1	7.5

Source: *World Bank:* EC 167/74
EC 167/80

Note:

(1) While data for periods 1965-1967 and 1970-72 are directly comparable because the source is one and the same, the data for 1977-1979 should be compared only between these years as movements showing orders of magnitude. A period-wise comparison is not possible because of differences in sources and coverage of compliation.

DEVELOPING COUNTRIE'S OUTSTANDING DEBT 1970-79

(percentages)

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Indicators										
Debt Ratio ...	8.9	9.2	9.0	8.8	7.1	8.4	8.4	9.5	12.4	12.6
Interest-service ratio	2.8	2.9	2.8	2.7	2.4	3.2	3.3	3.5	4.2	4.8
Capital-service ratio[a]	14.5	14.5	13.4	13.4	11.1	11.9	11.5	12.9	15.5	15.0
Debt/GNP (percentage)[b]	12.3	13.1	13.5	13.1	12.6	13.9	15.5	17.0	18.3	17.8
Debt/exports (percentage)[b]	80.1	85.2	81.8	70.0	59.6	72.1	75.6	79.6	86.6	78.3
Debt/reserves (percentage)[b]	263.7	239.9	183.2	153.9	143.5	193.9	204.6	214.5	217.3	176.4
Interest-service/GNP (percentage)[b] ...	0.4	0.4	0.5	0.5	0.5	0.6	0.7	0.7	0.9	1.1
Memo Item										
Total public debt outstanding and disbursed, all included countries (billion of dollars) ...	50.4	59.3	69.3	84.8	105.5	128.4	159.1	198.9	251.7	294.4

Note: Includes all developing countries that report to the World Bank's debt-reporting system except (1) the capital-surplus oil exporters; and (2) countries, for which complete and reliable time series data are not available (Afghanistan, Bahrain, Botswana, Burundi, Comoros, Guinea, Iran, Iraq, Lebanon, Lesotho, Liberia, Maldives, Nepal, Papua New Guinea, and South Africa).

a. Contractual service payments on long-term debt, plus remitted profits on direct investment divided by exports of goods and services.

b. Debt outstanding and disbursed.

Source: *"World Development Report"* 1981."

TABLE 13 SRI LANKA EXTERNAL DEBT OUTSTANDING (DISBURSED) AND RELATIVE GROWTH OF SUPPLIERS' CREDIT IN TOTAL DEBT 1969-1972 & 1976-1979

million US $

	Debt Outstanding (Disbursed)				Service Payments-Principal & Interest				
	Total	*Share of:* (a) *Suppliers' Credit*	(b) *Intern. Orgnzs.*	(c) *DAC Govts.*	*Total*	*Suppliers' Credit*	*Intern. Orgnzs.*	*DAC Govts.*	*Principal repayment Suppliers' Credit*
1969 ...	209.5	31.4	27.1	108.1	31.0	11.0	13.0	9.7	7.3
1970 ...	274.1	44.8	27.4	145.1	36.4	11.6	4.3	11.4	8.6
1971 ...	310.6	44.0	29.1	168.4	42.2	13.1	4.0	12.2	10.5
1972 ...	404.4	51.9	37.6	197.9	50.8	17.4	4.4	15.8	13.6
1976 ...	695.0	115.2	106.3	472.8	126.9	84.3	8.4	34.0	75.6
1977 ...	779.5	71.3	132.8	574.8	123.3	60.3	9.2	53.5	55.0
1978 ...	1012.7	51.1	221.0	740.3	88.9	34.9	10.3	43.6	31.0
1979 ...	1086.0	41.7	280.6	763.4	75.8	18.0	11.0	46.0	15.0

Note:

(1) DAG countries include Australia, Austria. Belgium, Canada, Denmark, France, Germany, Italy, Japan, the Netherlands, Norway, Portugal, Sweden, Switzerland, U.K., U.S.A. and New Zealand.

(2) Disbursement represent drawings on loan commitments and are shown in the year in which the drawing tates place.

Source: *World Bank:* *EC*/167/74 *pp.* 141-142
EC/167/80 *pp.* 160–161.

DEBTS-RELIEF AND INDICATORS

—A World Bank View

DEBT RELIEF

While most developing countries have been able to meet principal and interest payments on their external debt, some have been forced to seek debt relief. The circumstances leading to debt renegotiations have varied, but most had some similar basic features. These included balance-of-payments deterioration and excessively expansionary fiscal and monetary policies over several years which were aggravated by short-term shocks that is, shortfalls in exports or workers' remittances, sharp worsening of terms of trade and natural calamities. Some steps countries took to cope with these difficulties added to their problems. They borrowed at hardened terms. Private credit also sometimes had a destabilizing effect. For example, banks would lend when commodity prices were rising but would cut back when export earnings declined.

Debt relief has been arranged for a few countries through aid consortia; large sums have been involved and different aims pursued. Pakistan's public debt of $900 million was rescheduled in a series of agreements negotiated in aid consortia meetings from 1972 to 1974, and in 1981. India received $1.25 billion of debt relief between 1968 and 1976 (along with aid pledges and without interruptions to service payments) from the Aid Consortium mainly to improve the quality of aid at a time when debt-service payments were constraining India's access to free foreign exchange resources. Turkey received massive debt relief through the OECD in 1979 along with general economic assistance.

For 12 other developing countries over the past 25 years, debt relief on official or officially guaranteed debt (loans from governments and insured commercial credits) has been arranged through the Paris Club ad hoc meetings of representatives of the governments of creditor countries. In contrast with consortium meetings, the Paris Club has discussed only debt relief and not overall flows of foreign aid.

During the 1970s, loans from commercial banks have expanded rapidly, and debt relief has increasingly involved commercial banks. The restructuring of commercial banking debts has taken place in parallel with Paris Club agreements for Peru (1978), Sudan (1980), Turkey (1979) and Zaire (1980). In addition, there have been substantial refinancings of debt to commercial banks without Paris Club involvement: Argentina (1976), Jamaica (1979), Nicaragua (1980) and the Philippines (1970). Debt restructuring agreements with commercial banks since 1978 amount to $3.1 billion of which Turkey accounts for $2.3 billion.

Debt relief has been extended generally for periods of 12 to 18 months — on the condition that the debtor adopts a stabilization program (usually one approved of by the IMF or a stand-by agreement) to eliminate balance of payments difficulties. Repayment of rescheduled debts is normally over 7 to 10 years, including 3 to 4 years' grace. Interest charges on rescheduled debts are typically set at the rate for new loans of the type being rescheduled. Debt relief on concessional terms (low interest rates plus long repayment) has been extended only to India (noted above), Indonesia (where the entire outstanding debt was restructured in 1970), Ghana (1974) and Pakistan (1974 and 1981). Generally, debt relief has not been extended on previously rescheduled debt.

The Paris Club arrangements for debt relief provide for an orderly restructuring of external obligations when debtor countries have serious liquidity problems. But there has been continuing disagreement between debtor and creditor countries over the length of the consolidation period and the terms of repayment, reflecting different points of view regarding the purpose of debt relief. Most creditor countries' position is that the objective of debt relief is to help debtor countries recommence meeting their debt-service payments as scheduled and to restore their creditworthiness. Thus, a short consolidation period is considered appropriate so that debt relief can be adjusted to correspond to the country's changing capacity to repay. The debtor countries point out that when debt difficulties are deep-seated, short consolidation periods compel them to seek continuing debt relief and short repayment periods lead to a future bunching of debt-service obligations. They insist that debt renegotiations should take into account their future adjustment problems and about creditworthiness should take a longer-term view.

The best way for the international community to assist countries with large debt and poor export prospects remains unresolved, but increasingly relief as part of a viable package of foreign financing to support an economic program.

Source: "World Development Report 1981".

DEBT INDICATORS

There are two broad categories of debt indicators:

- Those that measure a country's capacity for making payments in foreign exchange. The most widely used of these is the debt-service ratio — interest and principal payments on long-term debt divided by exports of goods and services. Its meaning can seldom be easily interpreted: some countries have had little difficulty in managing their debt with a ratio of 40 percent or more, while others have had severe problems when debt-service payments were less than 10 percent of exports.

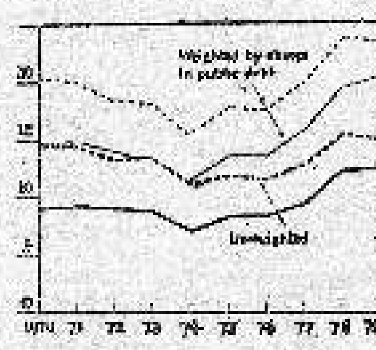
The apparent paradox is explained partly by how easily countries can borrow commercially. As long circumstances, the interest-service roll over principal repayments. In such management of an economy, they will as investors have confidence in the ratio—interest payments divided by exports of goods and services—may be a better indicator of the country's ability to make payments abroad, since it avoids the distorting effects caused by a bunching of repayments, prepayments, or refinancing.

- Those that measure a country's capacity to generate real resources (which can then be used to pay for imports and service debt). The ratio of interest payments to GNP is often used to illustrate the debt-service burden on an economy's productive capacity.

Some indicators—the ratio of external debt to foreign exchange reserves, for example—combine features of both types of measure. But none of them are an adequate substitute for detailed country analysis. In a period (like the 1970s) when debt is substituting for equity capital a country's capital-service ratio—contractual service payments on long-term debt, plus remitted profits on direct investment divided by exports of goods and services—may be the best guide to a country's creditworthiness.

As the table shows, the various measures have not always moved in line with each other, although all indicate a clear deterioration since 1974. Weighted by individual countries' shares in total public debt (so that the effect of countries with growing exports but low indebtedness on the average ratios is minimized) both the debt-service and the capital-service ratios increase more sharply during the 1970s (see figure), reflecting the high and rising debt of those countries that are currently the major borrowers.

Developing countries' debt-service and capital-service ratios, 1970-79



— — — Capital-service ratio
— — — Debt-service ratio

The Economy

Deteriorating terms of trade and balance of payment problems

The worsening balance of trade situation continued into 1981, with the merchandise trade deficit widening; and by the end of the first half of this year the adverse balance amounted to Rs. 9,034 million (SDR 407 million), according to latest Customs data. This compares with a deficit of Rs. 7,629 million of (SDR 369 million) recorded for the same period in 1980.

The terms of trade began to deteriorate sharply from 1979 and this adverse movement has continued since. It was a result of the sharp increase of import prices and volume, and the slow rate of growth in the export sector, specially the major exports. Thus, Sri Lanka's terms of trade or the purchasing power of its exports have declined by 28 percentage points in 1979, and 14 percentage points in 1980 and this trend has continued into 1981. The Central Bank shows that the terms of trade which deteriorated from 100 in 1978 to 72 in 1979; reached 58 for the year 1980.

The Central Bank commenting on the 1980 situation concluded that the terms of trade effect on the merchandise trade deficit would amount to more than 70 per cent of the total deficit

"A loss of real resources of this magnitude is unbearable to any economy, more so to a developing economy, with an on-going development programme to which the country is committed, and rather sluggish export sector which cannot keep pace with the sharp expansion of the import sector. Even though the deterioration of the terms of trade has been common to other developing countries in the region, the impact appears to have been less severe than in the case of Sri Lanka".

Further compounding the situation is the falling exchange rate of the rupee.

Sri Lanka's gross external assets had as a result reached its lowest position since 1977. According to provisional data, gross external assets in 1981 declined to Rs. 5,837 million (SDR 270 million) by the end of July 1981. In 1979 it stood at a peak of its 9,679 million. The decline occurred despite a drawing of Rs. 803 million under the IMF Extended Fund Facility. The assets of the Central Bank and of the commercial banks decreased by Rs. 439 million and Rs. 149 million, respectively. The level of gross external assets as at the end of the month was adequate to finance approximately two months' imports projected for 1981.

Balance of payment support had become necessary and on August 5 this year the Government agreed to a recommendation from the Minister of Finance to approve a US$ 75 million commercial loan. It was a Euro-dollar loan negotiated by the Ministry of Finance and Planning for 75 million US dollars from the Chemical Bank of America which is to be syndicated jointly with the Bank of Tokyo and the Indo-Suvez Bank of Asia.

According to the official bulletin: "This loan will be used to support the balance of payments and the Government budget in 1981. The loan will have a maturity period of eight years, a grace period of five years an interest rate of 5/8 per cent over the London Inter-bank offered rate for the first six years and $\frac{3}{4}$ per cent over for the balance two years. The loan has a commitment fee of $\frac{1}{2}$ per cent per annum on undrawn balances and a management fee of $\frac{1}{2}$ per cent of the total loan and an agency fee of 600 US dollars per annum. There are conditions for the reimbursement of expenses incurred by the banks in the negotiation and execution of the loan up to a maximum of 35,000 US dollars. Offers were received from four banks but terms offered by the Chemical Bank were the best and more advantageous than terms previously obtained in Sri Lanka in private capital markets."

The sharp worsening in the terms of trade from the end of 1979 has had a profound effect on the government budget, on inflation and on the balance of payments. Furthermore, the increase in the current account deficit greatly outpaced the growth in available concessional aid and investment flows forcing Sri Lanka to undertake commercial borrowing on a significant scale and, as pointed out, causing net reserves to decline for the first time since 1975.

The strong need for "stabilization" measures has been stressed by the World Bank in its report to the Aid Group meeting earlier this year. An important element in this stabilization task, it said, was the size of the current account deficit in the balance of payments, which had increased from 5% of GDP in 1978 to 19% of GDP in 1980. In one of its fore-casts the Bank indicated that in this situation the Government could easily find itself faced with a budget deficit amounting to 18% of GDP, requiring excessive borrowing from the Central Bank, and an external current account deficit of 21% of GDP, requiring a large drawdown in gross reserves and substantial external borrowing on commercial terms.

The balance of payments pressures resulting from this situation could force the Government to take undesirable restrictive measures. Thus, if the stabilization effort were relaxed in 1982, the Bank cautions, Government's import liberalization policy would be threatened and economic management greatly complicated. In particular, it would be extremely difficult in 1983 and 1984 to reverse the greater momentum which would have developed in the government investment programme; the large imbalance on the trade account, which could lead to speculation against the exchange rate; and the acceleration of inflation, which would result from the required adjustments in the exchange rate and its second effects on wages and government spending. In addition, both foreign indebtedness and the debt service burden would rise, to the detriment of future development programmes.

CENTRAL BANK TRADE INDICES (1978-100) - EXPORTS

Period	Price Index		Terms of Trade
	All Exports	All Imports	
1970	107	16	106
1971	104	17	98
1972	102	18	94
1973	103	24	82
1974	89	42	72
1975	107	49	58
1976	102	44	78
1977	94	54	102
1978	100	100	100
1979		152	72
1980		217	58

FEATURES

DEBT AND DEVELOPMENT.

JUAN C SANCHEZ ARNAU

Sanchez Arnau of France's Centre International du developpement (CID) maintains that a grave debt crisis is emerging in the Third World as a consequence of the recurring deficits in the balance of payments of most Third World countries, and which have so far been financed mainly through external borrowing. These poor countries whose deficits have been met so far by the transfer of concessional resources could also be strongly vulnerable to the present recessionist trends. The dramatic growth in the foreign debt of Third World countries threatens the very autonomy — both economic and political — of these countries and affects their sovereignty.

Primarily, the underlying cause of increasing indebtedness is the belief in and pursuance of a "development" model predicted on rapid increases in the GNP through the massive use of capital — both foreign and capital-absorbing. This strategy has led to increased dependence and the marginalisation of large segments of the population. To him only another approach to development, based on the enhancement of endogenous, creative and productive capacities, could assist the Third World out of this debt trap.

PRESENT SITUATION AND PROSPECTS

Much has been said and written about Third World indebtness problems and much more will be in the future. Industrialized countries are showing clear symptoms of generalized recession, and contrary to developments a few months ago, no optimism is now expressed about short and medium-term economic prospects. Recent OECD estimates, in the light of the latest increase in oil prices, are much more pessimistic than estimates made earlier this year. As in the past, industrialized countries will probably transfer much of the effects of this recession, or of its implicit costs of adjustment, to Third World countries. Greater protectionism, lower imports, export subsidies, a drop in official financial flows, more or less disguised expulsion of immigrant workers, will be amongst the measures bringing about this transfer. To these will be added the drop in some raw material prices due to the fall in demand.

The impact on the Third World will depend on the scale of the recession, and the time it will take industrialized countries, in particular the United States, to react, under the assumption that this is a more or less traditional cyclical crisis albeit aggravated by new elements, which can be escaped by adopting traditional neo-classical economic remedies. If, however, as many suspect, the present recession is rather an expression of structural problems affecting the very basis of the functioning of present growth models of the industrialized countries, then the impact of the recession on Third World countries will be greater and more prolonged. In such circumstances, the "debt" problem will become particularly relevant, since it will be the most obvious expression of the incapacity of many Third World countries to resist an aggravation of their balance of payments problems.

If the vulnerability of the external payments situation of many Third World countries has not yet emerged, this has been thanks to a sub-product of the recession and of the international monetary disorder: the high level of international liquidity. Without such a recession the transnational companies and the large companies of the industrialized world would have already absorbed most of the liquid resources available in world financial markets, which are at present being used to finance the Third World's indebtedness. Hence one of the paradoxes of the present situation: the same recession depriving many Third World countries of external resources derived from their exports or remittance of their migrant workers, is generating the liquidity enabling them to contract debts, thus escaping the risk of economic collapse.

This paradox can become a trap with few exits. If the industrialized countries took measure to limit this liquidity, which for orthodox economists is one of the main causes of the monetary disorders at the root of the present crisis, many countries resorting massively to indebtedness would be deprived of these resources, but continue to be faced with the other aspects of recession which have compelled them to contract new debts. And when there is a continuous series of increases in interest rates in industrialized countries and there are daily demands for a greater control on the issue of dollars and the activities of the Euro-market, is such a moment still far away?

In more cases than one, indebtness may well have been a well-calculated risk, and even a considerable drop in international liquidity within the framework of generalized recession would permit more than one considerably indebted country to escape the risk of problems, and the present situation and future prospects differ greatly default.

However, reservations must also be expressed on this possibility because there is not just "an indebtedness problem" but several from one country to another.

SIZE AND CHARACTERISTICS OF THIRD WORLD INDEBTNESS

The statistics published by the OECD on public and private disbursed debt show that from 1970 to 1977 the external indebtness increased from 72.9 billion to 244.8 billion dollars, growing at an annual rate varying from 12% in 1972 to 25% in 1975.

Non-official loans have increased their share of the total from 26.1% in 1968 to 41.1% in 1976, and this share has certainly continued to increase since.

On the basis of figures for the end of 1976, eleven Third World countries accounted for 60% of total public and private debt. i.e. some 115 billion dollars of a total of nearly 195 billion dollars.

While the debt problem is basically concentrated on this group of countries, the situation of many other Third World countries must also be studied to determine the future development of the problems.

On this basis, four types of situation could be considered. First, that of the two major debtors — Brazil and Mexico, with 25% of total Third World countries debt (25.8 billion and 21.7 billion dollars respectively at the end 1977). Their debt service ratio (debt service as percentage of exports) was in 1976 around 45% and 32%, on the basis of "World Financial Markets" data.

These countries' indebtness is growing and involves significant amounts of their future external resources, considerably burdening their present resources. But these are not exactly the countries which could present major problems in the short term. In the case of Mexico, because of its oil resources could enable it to meet debt service and in the case of Brazil, if its balance of payments problems worsened, its present creditors would be well advised to avoid a collapse which could have repercussions on the entire international banking system.

The second type of debtor country are countries like South Korea, Philippines, Argentina, Chile, Peru and Yugslavia. Most of them have adopted economic policies of increasing integration with the international market and are strongly oriented to promoting exports of manufacturers and semi-manufacturers. The debts of these countries will probably continue increasing so long as the present international liquidity situation prevails.

There will probably be exceptions, but in any case, this is a group of countries presenting many signs of external vulnerability with increasing indebtedness. Thus the debt service ratio of some of these countries is reaching high levels: 45% in Chile, 41% in Argentina, 28% in Peru (1976 data).

The third type of situation consists of the varied group of countries with fairly low per capita incomes, with an external debt essentially originating in public loans, with debt service ratios between 40 and 18 percent, whose external vulnerability arises from the lack of diversification of the economy, and low rates of growth. This group could include Pakistan, Egypt, Bolivia, Jamaica, Angola, Congo, Guina, Dominican Republic, Mauritania, Sudan, Togo, Bangladesh, Burma and Sri Lanka. Several of these countries also have debts of commercial orgin — either bank loans of suppliers' credits — with a significant share in their indebtedness.

According to the World Bank, countries with a per capita income of between 161 and 300 dollars — the category where the majority of this group of countries is included — showed the highest increase in indebtedness during the 1970's — 25% a year between 1970 and 1976. Private bank loans multiplied by 30 growing at 75% a year. Debt service increased at 26%, while interest payments increased faster than amortizations. Some countries inside this group might soon encounter serious payments difficulties.

Finally, the fourth group of countries is that which does not have debt, but depends, to a major degree, on grants of industrialized countries to finance their basic imports. This group includes many African countries. Some, like Ethiopia, often finance up to 100% of their current deficit with grants. The vulnerability of the group is very great. Serious concern for their economic future can be expressed if present recessionary trends worsen.

THE CAUSES OF THE INDEBTEDNESS PROCESS

The question now arises as to how such a large number of Third World countries could have arrived at such a high level of indebtedness, especially when most of their leaders realize that historically, indebtedness has been one of the most usual ways of losing important areas of economic autonomy, or even political independence.

However one analysis the indebtedness of the Third World it becomes clear that it is a central circular mechanism within the numerous vicious circles of underdevelopment. It is astonishing that this problem has so far been given only limited attention and that is has been viewed more as a consequence of underdevelopment than as one of its causes or at least as one of the pricipal means by which underdevelopment perpetuates itself.

In trying to give an answer to these questions, two basic types of situations should be distinguished. First, that corresponding to countries totally lacking in resources, with limited capacity or autonomy for self-financing. These countries, extremely dependent on foreign aid, have been unable — although in some cases one may wonder whether they had no other alternative — to escape from strong external indebtedness to maintain essential imports to ensure basic consumer levels.

The second, more common case relates to those countries whose indebtedness is strongly linked to the type or model of growth which they have chosen, or to the economic and social policy followed as a consequence of the adoption by the dominating groups of the ideology of development. This is the case that we shall now analyse.

DEVELOPMENT AS IDEOLOGY AND ITS CONSEQUENCES ON INDEBTEDNESS.*

In the Third World "development has become an tergral part of the national ideology". The simple-minded idea that one or two fiive-year plans making massive use of equipment supplied by the industrialized countries can give a country a chance of qickly "catchin up" with the industrialized countries has often been the corollary of such an ideology. Bogus pseudo-scientific mathematical equations of the growth of revenue, based on investment/production ratios through capital coefficients, have lent additional legitimacy to the plans of Third World countries. These mechanistic calculations have been enriched by various more or less brilliant and superficial theories, which are almost always designed to justify a special drive for massive investments in the "modern" industrial sector, which is supposed to generate spin-off effects which will greatly accelerate a country's progress.

The majority of these theories leave aside an important historical consideration, that practically no country has industrialized or "developed" only with foreign technology, and much less by importing capital goods. Examples of exaggerated "Europenization" and "modernization" in the 19th century (Ottoman Empire, Egypt, Tunisia, Iran, certain Latin American countries) were numerous but in all cases the final result was financial bankruptcy and the strengthening of foreign presence in the administration of the countries, and even, n some cases, the loss of political independence.

Generally speaking, the "development" theories based on this ideology have all helped set in motion a scramble for investments intended to bring about modernizaton; these investments have thus led ta massive and abrupt imports of production equipment from abroad and have driven the Third World deep into the technological trade circuits run by the TNC, with

* For the drafting of this section and the final conclusion of this paper, extensive use has been made of a document prepared by G. Corm for CID ("L' endettement des pays en voie de development. Origines et mecanismes") within an IFDA project on "Debt and development"; but, of course, responsibility for the ideas expressed here is the author's.

a final result — the deepest indebtedness process of modern history.

The enquiry into the origins of the Third World led us to emphasise the sequence: process of acculturation — transfer of technology — indebtedness. From a historical point of view, the process of acculturation initially manifests itself in the military sphere, where the overwhelming superiority of the industrialised countries since the 19th century has obliged the Third World to borrow Western technology. It then spreads gradually to the other spheres of the life of a society, and it is in this way that the aspiration to the model of consumption of the industrialised countries becomes generally accepted, and it is not possible to satisfy the demand of a model but through technological borrowing, usually taking the form of the massive and indiscriminate import of the products of technology, and not of a global and sustained effort to acquire a command of technology. Whether they are military or whether they consist of capital equipment for the production of consumer goods, the equipment imported by the Third World is no sense a transfer of technology. At most they constitute a transfer of productive capacity, the excessive cost of which is apparent only over a long period and blocks the dissemination of progress locally, and the egalitarian and profitable insertion of the country into the circuits of international trade.

The real accumulation of capital which enriches society is that which lies in the capacity to produce productive capacity, and not in the expansion of the capacity to import productive capacities from abroad. In this sense the mechanisms for the "transfer" of technology from the industrialized countries to the countries of the World, as they have been used in practice since the last century, are precisely those which help the industrialized countries to develop even further their technological capacity, while the Third World becomes more and more dependent and lags further and futher behind. Whatever capital is imported, the added value created in the exporting country far exceeds that in the importing country; the genuine spin-off effects takes place in the country of origin of the equipment and not in the receiving country.

On the basis of this ideology of "development", a model has been developed for an accelerated process of industrialization based on external investments and massive indebtedness to import capital goods or generating new exports. The hypothesis has been that it would be finally possible to amortise those capital flows and debts contracted abroad. In fact, this type of approach has perfectly coincided with the interests of the transnational companies, in favour of a new international division of labour better suited to their global interest.

It is evident to that the industrialised countries and their TNCs are doing their best to promote a new international division of labour (IDL) in keeping with the technological evolution of their production apparatus and its profitability. Nonetheless we feel it is risky to attempt to formulate a global theory for the functioning of the IDL as a mechanism from which the Third World countries cannot escape, because the very essence of the IDL is the fact that countries cannot escape, because the very essence of the IDL is the fact that it is constantly moving in response to the obstacles or the opportunities with which the TNCs — the main actors on today's economic scene — are faced.

But the gradul take-over of the economies of Third World countries by the TNCs is not merely a result of the excessive power of the industrialised countries. As in the 19th century, the integration of the Third World on unequal terms in the trade circuits dominated by the industrialized countries is due quite as much to the nature of the local economic policies, which reflect, above all, the interests of the dominant groups in Third World countries. It seems to us that the 20th century is repeating the unfortunate experience of the 19th century, when the lack of interest in an autonomous effort to achieve a mastery of the technological processes at the national level meant that the policies of modernization were doomed to be nothing more than an instrument for the promotion of the supremacy of the industrialized countries. The current phase, which, for the countries of the Third World has lasted since 1950, indicates that there has been a dangerous acceleration of their technological/financial dependence, in the form of a faster rise in rates of indebtedness as well as the undisputed supremacy of the TNCs in the execution of all major investments in the Third World. Whether the technology-consuming countries have liberal regimes favouring joint ventures with the TNCs or whether they have regimes of State capitalism and use turnkey arrangements the result is the same: a passive consumption of technology, and an increasingly fragmented economy and the loss of control over the ecosystem implied by the decline of agriculture and by uncontrolled urban growth.

MECHANISMS OF INDEBTEDNESS

Following the description of the basic causes indebtedness, the mechanisms through which it is achieved will be described.

The "development" model generally adopted in Third World countries with more or less chronic indebtedness problems is centered on the satisfaction of the demand of those groups in society with the highest purchasing power, interested in copying consumption models in industrialized societies. This is achieved through a process of modernization of the infrastructure and an accelerated industrialization process based on import substitution.

Both processes are linked and mutually reinforced. This can be illustrated by the introduction of motorcar manufacture or assembly, requiring the construction of roads, which in turn require the development of a road equipment industry. This kind of process leads many development theorists to maintain that it is self-sustaining. But the reality is slightly different.

The establishment of the motorcar industry is within the reach of only very few countries. Capital needs are huge and though technology is very dispersed it is always in the hands of the transnational companies dominating the world car market. Consequently, there is a need for foreign investment by TNCs at least to establish terminal plants.

Local sub-contracting factories then develop around these plants, many of which are small or medium-sized national companies resorting to public credit to start up and develop operations and needing State guarantees to obtain foreign credits needed to import capital goods. Many in turn are associated to other foreign firms providing them with the technology necessary to manufacture automobile parts. Generally, the percentages of national integration of the final product is not very high, since often the TNCs controlling the motor car plant prefer to import parts from other countries as a function of their overall costs or intra-firm financial movements. On the other hand, the State embarks on ambitious road construction programmes, even though they have a low coefficient of use, except around the big cities, and although other public services such as railways are outdated and overloaded with passengers — most of whom, moreover, will never be able to own a car.

In order to build these road, the State will resort to credits extended by international organisations and will use the services of foreign consulting engineering firms to satisfy the technical requirements of these organisations. Also, the State will import road equipment, or if the programme is very ambitious, will promote the establishment of a road equipment industry, resorting to other specialised TNCs, which in turn will resort to local companies for the manufacture of some of the necessary parts.

The result of this series of operations will imply: a degree of indebtedness with respect to credits accompanying the entry of foreign capital; further indebtedness for capital goods imports of local companies manufacturing parts; the increase in imports corresponding to parts not manufactured locally and further sums for inputs to be used in the manufacture of parts. If the country has no oil, then there will also be an increase in oil imports, and in refined products, and perhaps also a plant to refine imported oil. Most of these imports except for oil, will be on credit, backed by a government guarantee. The State will have in turn contracted debts for the roadbuilding programme.

The volume of debt generated in this way can be considerable, but it is assumed that the development of the motorcar industry will result in an increase in economic activity permitting increased exports of other products. This increase will cover the payment of debt service and the regular increase in imports of inputs, renewal of equipment and fuels.

The problem begins when it becomes evident that the massive introduction of the motor car, while satisfying the expectations of most of the middle and upper income groups, not only has not solved the transport problem, but has not generated greater exports, whether directly or indirectly, which can look after the indebtedness on which it was based. Something similar happens with the television industry, with refrigerators, radios and other consumer durables, which will have contributed to increasing the welfare of population groups with purchasing power and increasing GNP...... but also indebtedness.

In relation to the economy as a whole, when based on the economic model described here, various factors cause the indebtedness which are reflected in the following manner in the balance of payments. First, the increase in imports of capital goods not financed by foreign investments. To these should be added increased imports of inputs. Significantly, the further the industrialisation advances according to the model described, the more difficult it becomes to limit or diminish such imports of inputs. The reason is that industrial sectors which have emerged through this process become the most dynamic centres of the economy and ithus becomes almost impossible to restrict imports of inputs without endangering the rythm of economic activity and the level of employment. Thus when balance of payments problems start becoming serious, it is usual for governments to run away from their problems by promoting new investments to increase import substitution, but since investments are usually made on the same basis as their predecessors, the balance of payments effects of this substitution are cancelled out over time.

Second, there is an increase in payments and remittances made by foreign companies. These can become so large that normally the balance of inflows from investments plus eventual exports they generate are less than outflows for dividends, capital repatriation of part of the principal, royalties for patents and trade marks and additional imports.

Factors such overbilling which takes place in tra-firm transactions, the burden on Third World countries arising from R and D expenditures already amortized in the industrialised countries, have also a role in this process. Statistical analysis carried out in Latin American countries clearly demonstrate the above. In addition, a good part of the profits made by the TNSs are at the expense either local credit, or external credits with the official guarantee of the host country, when not based on tax breaks offered to attract investments. Taken together, all these factors give a clearer view of the negative impact of this type of investment on the balance of payments.

But balance of payments problems also have other origins. One of them, little analysted until the present, is the financial cost of their external debts incurred to promote public works. Dut to the basket of currencies in which the loans of some international financial organizations are expresser, their real cost is much higher — due to the constant appreciation of some of these currencies — than the nominal rate of loans.

Thus, for example, the IBRD, which is financed largely on the Japanese, German and Swiss national markets, passes on exchange rate risks wholly to its debtors, who thus find the actual rate of interest charged on their borrowings from the IMRD marked up several points above the nominal rate.*

Also, expenditures on armaments should be mentioned as one of the usual causes of excessive indebtedness.

Data on this type of expenditure is scarce and is never reflected in official indebtedness figures but each time that a country has come forward to rennegotiate its external debt, it has been possible to infer that mist of the differences between figures by creditors and debtors was due to unregistered purchases of military material, due to its confidentiality, in the books of the central monetary authority. Of course this does not give even a vague idea of the burden of financing such purchases on the indebtedness of many poor countries, but permits the assumption that in many Third World countries indebtedness is considerably higher than the official figures.

* An article published in 1978 in a Colombian review edited by former Minister of the Economy, stated that Colombia was: "....paying to the World Bankan approximate rate of interest in dollars of 18% for the portion of our debt expressed in Swiss francs, and a dollar interest of 15% for the portion of our debt expressed in DM" and it compared these rates with that of 7.6% payable on month to month Eurodollar loans in December 1977. In "Estrategia economica y financiera", Bogota: March 1978.

The theoretical models of this type of development assume that all these pressures on the balance of payments will be compensated by increased exports arising out of steeped economic activity. However, this is not normally the case, due to the weakness of the exporting sector of most Third World countries (with the predominace of products characterized by unstable prices, some declining over the long term) and difficulties in moving from export of primary products to exports of manufactures. Also it is due to the influence of the growth in internal demand, the inefficiency of industries which have been developed on the basis of high tariff protection and thus cannot complete with costs on the international market, and finally due to the increasing protectionism of industrialised countries against products in which Third World countries have managed to become competitive.

The result of this lack of symmetry between growth of imports and outflows on current account and the slow growth of exports is a more or less chronic deficit in the balance of payments, leading to increasing indebtedness, described earlier.

In recent years, the governments of some Third World countries, in particular in Latin America, have chosen to apply a model whose final objectives are the same — to satisfy the demand of the sectors with the highest purchasing power but which are achieved under different policies. These have consisted in eliminating external protection benefitting their industries, while proceeding to major income redistribution resulting in the notable drop in real wages, while promoting the entry of foreign capital and meeting balance of paymets problems by increasing indebtedness in the form of bank loans.

These policies have been aimed at making their industry "competitive" and facilitating the increase of exports of manufactures and semi-manufactures, based on low labour costs and in some cases on the availability of comparative advantages derived from the low production costs of certain inputs.

Until now, the result has been almost the same in all cases. First, a huge social cost, in terms of high unemployment and repressive measures to oblige wage earners to accept the reduction of their real earnings as well as the weight of income redistribution in favour of higher income groups, assumed to have a higher propensity to save and invest.

Second, a major recession which in many cases has resulted in significant drops in GNP. Third, the liquidation of a considerable part of national industry, due to the interplay of falling sales due to the recession, competition from imports whose entry is favoured by the dismantling of effective protection and by the exchange policies and the high cost of money due to the freeing of interest rates. Fourth, the emergence of a new financial class, cornering most of the benefits of this type of policy and which has replaced the previous industrial — which has turned to speculative activities or the import of products it used to manufacture. The entry of foreign capital in the form of direct investments have not been very great in any case — except perhaps when it has been for the sale of public companies or the handing over to private interests of natural resources previously nationalised. Inflation has reached impressive levels and indebtedness which it was thought could be rapidly eliminated has either remained at the same level, or grown, due to the increase in imports arising from the liquidation of industry and tariff dismantling, as well as to the disappointing performance of exports — due either to internal production problems, to difficulties of access to markets of industrialised countries, or to decreasing demand due to the general recession.

In the case of countries which have not followed the traditional model, when they reach a critical point in their indebtedness, they have either had to postpone the markets for loans to amortise pre- problem by resort to the capital markets for loans to amortize previous debts, or to the International Monetary Fund to obtain short-term financing in exchange for applying the recessionary policies favoured by the IMF with their known consequences, or in most critical cases to further debt rescheduling, with equal or graver consequences.*

As can bee seen these are all dead ends arrived at by the development paradigm and adoption — or imposition — of development models only taking into account the interest of a part of society.

CONCLUSION

An exhaustive study of the "development" paradigm clearly goes well beyond the limits of this paper. We hope, however, that our efforts to situate the phenomenon of indebtedness in a broader framework will help dispel the illusions of the purely economic approach, which prevails in the literature on development and underdevelopment as well as in the solutions advocated to escape the "bottlenecks" and "vicious circles" of underdevelopment.

For this reason we think that there is no isolated remedy to the problem of the excessive indebtedness of the Third World, and no neat financial prescription. The recurrence of indebtedness and its increase have to do with the overall functioning of exploited and blocked societies, and thus, in the last analysis, with the very nature of the kind of society intended by their ruling elites.

To change the pattern of development and breaking the thousand and one links between technological dependance and financial dependence is a long business which involves upsetting large numbers of conventional notions about development. Yet only such a break with the past is capable of bringing about new types of planning, based as a matter of priority on an internal command of the national economy and of technology, and in the mobilization of internal savings in order to disseminate local productivity. It alone is capable of breaking the mechanisms of excessive profit of the TNCs and, therefore, the mechanisms of unequal trade which is reproduced, on an amplified scale, from century to century, as the technological gap between industrialised and Third World countries continues to widen. It is only in this framework that alternative models for development can begin to take shape.

* Sid-Ahmed, Abdelkader "The IMF Conditionality" document prepared for the CID project on "Debt and Development" to be published as a Third World Forum Occasional Paper; Lichtensztejn, S. and Quijano, José M. "LDC debt and international private banking" and Martner, Gonzalo G. "Multinational Debt Renegotiation", documents of the above project.

The Rubber Market Situation

By M. Nadarajah

Sri Lanka's RSS and Latex Crepe can both get good prices if the presentation and marketing of these rubbers is improved. A rehabilitation of Sri Lanka's rubber industry will also require a planned approach at Governmental level for manufacture of rubber based products and for providing central processing facilities to the private sector, particularly small holders; maintains M. Nadarajah, an FPRI and FI Chem. (Ceylon), who was for several years a senior officer of Sri Lanka's Rubber Research Institute and is now a Marketing Consultant to the rubber industry and trade.

Natural rubber (hevea brasiliensis) has been in existence in Sri Lanka for the last hundred years. It is of vital significance to the three major plantation districts of Kegalle, Kalutara and Ratnapura; it accounts for about 15 per cent of Sri Lanka's export earnings; and provides employment for about 500,000 persons engaged in all aspects of the industry. The future rapid expansion of rubber production in Sri Lanka is limited as there is lack of suitable new land for planting with Hevea brasiliensis; due to neglect of replanting the yearly production may drop to even as low as 100,000 tonnes per year in 1986 from the present 130,000 tonnes and for the continued prosperity of the rubber industry, the years of neglected replanting must be caught up. Whilst there is no suitable land for new rubber planting in the wet zone to grow Hevea Brasiliensis there may be suitable arid areas in the North and East of Sri Lanka to plant guayule which is also a source of natural rubber. Guayule is a shrub native to the deserts of Mexico and Texas USA and steps are being taken by these two countries to commercially exploit this shrub as a source of natural rubber.

Though natural rubber is important to Sri Lanka as regards employment and foreign exchange earnings, it is comparatively a very small producer of rubber. In 1980 Sri Lanka produced about 133,000 tonnes of natural rubber with a world consumption of natural rubber of about 3,850,000 tonnes and a total natural and synthetic rubber consumption of about 12,450,000 tonnes. Thus Sri Lanka production is about one per cent of world rubber consumption.

When considering the marketing of even this small amount of rubber, it is necessary that the highest market value be obtained for the rubber produced. Today, Sri Lankan rubber is sold and not marketed. The difference between selling and marketing is that selling focusses on the needs of the seller and marketing on the needs of buyer. As long as NR is in short supply it can be easily sold but if there is a difficulty in selling and getting fair prices, then it must be marketed. Synthetic rubber (SR) production which has grown during the last 40 years from nil to a yearly consumption of nine million tonnes owes its success to its modern methods of marketing Whilst SR is marketed as an industrial raw material and sold direct to its consumers through a technical salesman, NR is traded in a manner similar to most agricultural primary commodities. Only Malaysia of all the natural rubber producers have made some effort at natural rubber marketing. Thus though NR is superior to SR in many respects, this has not been sufficiently impressed on consumers and this is one of the reasons for the depressed NR prices. Further, the demand of consumers is increasing year by year as far as the quality of NR is concerned. The main reason is that simple finished goods which are easy to manufacture are being produced in the developing countries and also in the NR producing countries where wages are low and only the very complicated compounds are being processed in developed countries, and this means that the raw materials must have a high quality standard. A type of NR in demand is the constant viscosity type and Sri Lanka should endeavour to produce and market this special rubber by the addition of a viscosity stabiliser and if necessary a peptising agent.

Table 1 gives the types of NR produced in Sri Lanka in 1979 and 1980.

TABLE 1 TYPES OF NR IN TONNES PRODUCED IN SRI LANKA

Type of Rubber	*Year* 1979	1980
RSS	81,800	72,400
Latex Crepe	36,300	31,800
Scrape Crepe	15,500	13,400
Sole crepe	4,800	4,300
Latex	1,100	1,500
Technically specified rubber (TSR)	13,200	9,700
Total	152,700	133,100

RSS

It will be seen that RSS is a major rubber produced in Sri Lanka. From 1952 upto very recently the export RSS 1, 2 and 3 was the monopoly of the Sri Lankan Government and nearly all of it was sold on a barter agreement to China at prices higher than those obtaining in the open market. This price was passed down by the Government to the small holder and this has had a stagnant effect on the rubber processing industry in Sri Lanka in that it severely limited efforts to divert small holders latex to other types of specialised rubbers such as centrifuged latex, latex crepe and technically specified rubbers. Thus Dunlops Limited who had a centrifuging plant in Sri Lanka and were exporting 5,000 tonnes of rubber as centrifuged latex closed their plant in 1957. Further the State Rubber Manufacturing Corporation who were manufacturing a technically specified rubber SLR5L from small holders latex had to be given a duty rebate to be viable.

Now RSS 1, 2 and 3 can be exported by the private trade but finding markets takes time. It has been the practice for the last 30 years not to press the RSS during baling as this was a requirement by the Sri Lankan Government to facilitate easy inspection of rubber being shipped to China, by surveyors of the Commissioner of Commodity Purchase. However, if the RSS is not adequately pressed during baling 1) the bales get out of shape and are difficult to handle 2) moist air can get into the rubber sheets and cause the formation of mould. If RSS is to be exported in the open market, it will have to be well pressed. Very few shippers have at present the necessary presses or experience in pressing. This problem of improved pressing must be solved without delay. Otherwise it will not be possible to improve the image of the Sri Lankan RSS quality overseas. Consumers require well pressed RSS bales free from mould.

LATEX CREPE

Sri Lanka is the world's largest producer of thick latex crepe. The reason for Sri Lanka producing thick rather than thin crepe is that packing is not done by the producer but by the shipper and this delay in packing is more liable to cause mould growth in thin crepe than in thick crepe, and mould is a very serious defect in latex crepe. If thin crepe is to be exported, then a fraction must be removed and hot air drying to give improved mould resistance to the thin crepe.

Malaysia also produces latex crepe, but after 1970, has been agressively promoting the technically specified rubber SMRL as a competitor to latex crepe. We have done nothing to counter this competition and if this goes on Sri Lankan latex crepe will suffer a natural death. At present marketing of Sri Lankan latex crepe is only on colour and not on technological properties and in future technological marketing will also be needed. Sri Lanka should produce latex crepe grades superior to SMRL not only in colour but also in technological properties and advertise and market these grades to the consumer. In the case of SMRL it is not possible to take a fraction, whilst this is possible with latex crepe. Hence a policy decision should be taken to produce almost all Sri Lankan latex crepe after taking a fraction. This was advocated by me as far back as 1971, but it has still not received the attention it deserves. There would be two grades marketed. They are

A) a fraction taken and no bleaching agent used
B) a fraction taken and a bleaching agent used

Grade A would be the purest form of natural rubber with no toxic chemicals in it and would be used to manufacture rubber products for surgical and pharmaceutical use. An important use of latex crepe is to make remilled sole crepe and either grade A or grade B could be used for this purpose.

Since Sri Lanka is the world's main producer of latex crepe, forward sales for at least one year should be permitted for latex crepe rather than the six months permitted at present.

It is necessary to point out that the use of boric acid as a secondary preservative in the manufacture of L can cause serious problems to the consumer which problems are not encountered if latex crepe. Sufficient market promotion has not been done as yet by Sri Lanka to highlight this superiority.

SOLE CREPE

Though sole crepe production originated in Sri Lanka, Malaysia is the world's biggest producer of sole crepe with a production of 20,000 tonnes per year. Sri Lanka produces about 5,000 tonnes of sole crepe per year and remilled sole crepe at about 22,000 tonnes per year were manufactured in Italy-USA and Western Europe, using as the principal raw material Sri Lankan latex crepe. The quality of remilled sole crepe is inferior to top quality plantation sole crepe and consumer reaction has resulted in there being a reduced demand for remilled sole crepe. This reduction of an important demand for Sri Lankan latex crepe is a reason for the inadequate prices fetched at present for our latex crepe. A remedy would be to produce top quality plantation sole crepe to meet world demand rather than exporting our latex crepe for conversion to an inferior remilled sole crepe.

The production of sole crepe in Malaysia is expected to show a steady decline due to serious shortages of labour in that country, as sole crepe manufacture is labour intensive. Sole crepe can be considered a product and there is no other rubber product which uses as much labour as sole crepe. Hence the Sri Lankan Government should seriously consider giving some of the incentives offered for rubber products to any private industrialist who wishes to make sole crepe using crepe laces with a fraction removed as the raw material. The incentives suggested are investment relief and a tax holiday.

Further, since sole crepe is a product used in footwear in temperate countries, and having no other use, it should only be produced on forward orders. At present only forward sales for a period of six months are allowed. However to promote increased sole production in Sri Lanka, forward sales for a period of two years should be permitted.

The importance of technological market promotion of sole crepe and of latex crepe was highlighted at the Centenary International Rubber Conference held in Sri Lanka as far back as 1976. Sales promotion means advertising our product in a systematic manner and the after sales service will ensure that our customers will stay with us and will also speak about the service we provide, which makes the use of our product so easy. However there has been a serious lack of significant technological promotion of Sri Lankan rubbers.

TECHNICALLY SPECIFIED RUBBERS

Sri Lanka produced in 1980 about 13,000 tonnes of scrap crepe and a fair amount of RSS 4 and 5. These can be blended and converted to technical specified rubbers of the SLR 10 or SLR 20 to give a higher value and a better product rather than exporting them as scrape crepe on low grade RSS. This should be possible as licenses have been recently granted by the Sri Lankan Government to eight additional block rubber factories thus enabling more than 50,000 tonnes of TSR to be produced in Sri Lanka. The production of TSR in 1980 was about 10,000 tonnes.

SMALL HOLDERS' RUBBER...

About 67 per cent of rubber land in Sri Lanka is owned by small holders who produce about 50 per cent of Sri Lankan rubber. To enable them to produce high quality rubber, it is necessary to centralise their manufacture. The product could be as RSS, latex crepe, TSR (5L) or centrifuged latex. Some success has already been achieved in this respect.

In RSS manufacture there are in Sri Lanka over hundred Group Processing Centres producing about 4,000 tonnes of high quality RSS using small holder latex. Some success has a lsobeen achieved in latex crepe manufacture using small holder latex. The SRMC manufactures about 1,600 tonnes of high quality latex crepe annually, several private sector factories are making high quality latex crepe and sole crepe, and organisations such as the SPC, JEDB and the BRISL are making some latex crepe. However the total amount of such latex crepe produced would be about 3,000 tonnes per year. The SRMC also produces annually about 2,000 tonnes of SLRSL which is a TSR from small holder lated. The SRMC, Ceylon Co-operative Industries Union Ltd. and Glowcave Rubber Ltd. are manufacturing centrifuged latex using small holder latex and they use about 1,000 tonnes of rubber as latex. Thus central processing caters for only about 10,000 tonnes of small holders latex rubber, whilst the amount available is as high as 50,000 tonnes.

Hence, greater emphasis must continue to be given to the central processing of small holder latex rubber, price for the latex produced by him.

RELATIONSHIP BETWEEN RSS1 PRICES AND PRICES OF OTHER GRADES OF RUBBERS

RSS1 has always been adopted as the yardstick in trading natural rubber. The prices of the other rubbers are always influenced by the RSS1 price but their degree of fluctuation is notably less than for RSS1. This is because RSS1 is the only grade used for hedging purposes and its price is called a "paper" price as against a "physical" price.

In all major rubber markets, there exists "physical" and "futures" markets. In the physical market trading involves delivery of physical rubber. In the futures market, trading is not intended for the delivery of physical rubber but is done for hedging purposes against any risk of price fluctuations. This is called "paper" rubber. The rubber market is very sensitive to economic, monetary and political developments in the producing and consuming countries.

Prices of RSS 1 quoted by the Commissioner of Commodity Purchase based on the Singapore FOB market are nearly always higher than the CRTA price for RSS 1 in the Colombo market as the freight is not correctly computed. The Commissioner of Commodity Purchase is therefore not in a position to physically buy all the RSS 1 offered at the prices advertised by him.

CONCLUSION

In conclusion it can be stated that Sri Lanka is a producer of high quality rubber whether it is RSS, latex crepe or sole crepe.

a) There is still a world demand for RSS and Sri Lankan RSS can get the good prices it deserves if she improves the presentation and marketing of her RSS;

b) Sri Lanka is the world's largest producer of latex crepe but because of lack of market promotion its use is being superseded by the block rubber which can be considered an inferior product. With the necessary market promotion and improved presentation of our latex crepe in 33 1/3 Kg or 50 kg bales in block form good prices can be obtained for our latex crepe. Further its production can be easily stepped up in the existing crepe factories to cater for any increased demands;

c) A planned approach at Governmental level is necessary to step up the manufacture of products based on natural rubber for export. In this context it is necessary for the Sri Lankan Government to accept that sole crepe is also a finished product which suffers from high import duties from consuming countries and that its production in Sri Lanka should be actively encouraged;

d) Central processing facilities must be provided by the Sri Lankan Government and to some extent by the private sector, to the smallholders who produce about 50 per cent of Sri Lankan rubber. This could be done easily by the Government as nearly all the major raw rubber processing units in Sri Lanka are Government owned and come under the DRISL, SPC, JEDB and RRMC. These organisations have the necessary expertise and hence should play a key role in stepping up the quality of smallholders' rubber to enable small holders to get fair prices for their rubber.

Natural Rubber: A Better Future

The market conditions for a better future for natural rubber seem to be in place: it is up to the producers to take advantage of this opportunity, argues Grilli, the present Chief of the Commodities and Export Projections Division of the World Bank. Reproduced here are conclusions from his recent paper on **"The World Rubber Economy: Structure, Changes, and Prospects".**

In 1973, the world rubber economy suffered its first severe jolt: the oil crisis and subsequent sharp rise in crude oil prices and then the recession in the industrial countries. For synthetic rubber, which depends so heavily on petrochemicals, the sudden drastic increase in crude oil prices in 1973-74 implied a major change in costs and production (see Chart 1). As much as 70 per cent of the production cost of synthetic rubbers depends on the costs of petrochemical ingredients and energy. Between 1973 and 1975 these costs more than doubled, labor and overhead charges went up, and as a result, the average cost of producing synthetic rubber from existing facilities increased by 50 per cent to 100 per cent in the industrial countries.

Natural rubber was less affected directly—the average direct cost of producing rubber in Malaysia went up by about 30 per cent between 1971 and 1974. The industry was, however, still subject to all the indirect effects of the oil crisis: acceleration of world inflation, changes in consumer expectations, and rising doubts about the long term future of world demand for rubber in the energy-intensive automotive sector.

Doubts about the long-term future of the rubber industry deepened during the economic recession that affected the industrialised countries after 1973. As industrial production fell, so did the output of the automotive industry, and so did world demand for rubber. Between 1973 and 1980 the price of crude oil again increased sharply in real terms, bringing the cumulative increase since 1973 to more than 400 per cent. Costs and prices of synthetic rubbers went up again and the expected profitability of new investments, facing in addition to severe cost pressures a more uncertain outlook for demand, deteriorated further. Actual investments as well as plans for new investments in synthetic rubber capacity have virtually come to a halt outside the centrally planned economies.

It is generally expected that the future rate of expansion of world demand for all rubbers will be below historical trends in the next 10-15 years—perhaps by as much as 1 to 1.5 per cent per annum. These expectations are borne out by detailed analysis of future world demand for rubbers. The basis for this analysis is, first, the prospects of slower growth in economic activity in the 1980s and, second, the structural changes expected in the relationships between economic activity and rubber demand, brought about by changes in consumer choices in transportation and by government policies affecting the production and use of motor vehicles.

This slowdown is likely to be more visible in industrialized countries, where the major structural changes in demand are expected to occur and where demand for rubber is already high. The reduction in demand is likely to be less marked in the centrally planned economies, where the consumption of rubber is lower and is less affected by consumer choice and by changes in income and industrial production. Strong growth is still expected to continue in developing countries, particularly in high-income developing countries, where the use of motor vehicles is increasing.

BETTER MARKET PROSPECTS

A key question posed by these developments is whether the relative market position and future prospects for natural rubber have also deteriorated with the worsening prospects for the overall demand for rubbers. The prospects for rubber depend critically on the competitive position of natural vis-a-vis synthetic rubbers and on those developments of technology that affect the choice of rubber inputs in the production of rubber products. Analysis of these factors shows that on both counts natural rubber is potentially in a better market position than at any other time in the recent past.

The long-term competitiveness of producing natural rubber from existing trees has improved considerably, given the evolution of costs and prices in the second half of the 1970s. It is estimated, for example, that to have invested profitably in SBR production in Western Europe in 1977, the industry would have needed future real prices of at least 40 cents per pound. Equally profitable investments in natural rubber in Malaysia would have required a future real price of about 35 cents per pound. The profitability of natural rubber investment would have been even greater in relation to kinds of synthetic rubbers such as polyisoprene. The 60 per cent increase in the real price of oil between 1977 and 1980 has added at least another 7 cents a pound to the future expected price necessary to invest profitably in SBR. The crude oil price increases expected price necessary to invest increases expected in the 1980s will further improve the long-run competitiveness of natural rubber.

Closely reflecting the climb in the prices of synthetic rubbers (which in turn followed the upward trend set by crude oil prices), the prices of naatural rubber increased markedly in the second half of the 1970s (see Chart 4). Natural rubber price trends are set to a large extent by those of synthetic rubbers. While in the late 1906s, falling synthetic rubber prices pulled down nautral rubber prices since 1973. More important yet, rising synthetic rubber prices and favourable product deveJoptments— such as the spreading use of radial tires, which require relatively more natural rubber than other types of tires—have contributed to reverse the long-term decline in the real price of natural rubber. After fallling by more than one half in the 1960s, real prices of natural rubber have increased by about 45 per cent between 1972 and 1979. This reversal is not likely to be a temporary phenomenon. It is expected that the real prices will continue to increase in the 1980s, as demand for natural rubber goes up and the prices of synthetic substitutes follow the trend set by rising real energy costs.

Another reason to be sanguine about the future for natural rubber is that the scope or future productivity gains in the synthetic rubber sector appears to be more limited than it was. Outside the field of specialty rubbers, technological innovations in production and economies of scale, which were the major factors behind the exceptionally fast growth of general-purpose rubbers in the postwar period, appear to have almost run their course. Their future effect is likely to be much less strong than in the 1950s and 1960s—although it will by no means be negligible. The synthetic rubber industry outside the centrally planned economies is reaching a nature stage where emphasis is likely to be on rationalization, consolidation, and better planned growth. Inside the centrally plannned economies . expansion programs are likely to continue for the sake of self-sufficiency, regardless of developments in world rubber markets.

Apart from these economic constraints to further rapid growth, the synthetic rubber industry will also face greater uncertainties than in the past about the availability and prices of chemical feedstocks and mounting pressures over environmental and haelth issues.

EXPLOITING THE POTENTIAL

The natural rubber industry is in a favourable position to take advantage of the present good market opportunities. Despite these favorable prospects, however, natural rubber producers will need to fulfill several important conditions in order to take full advantage of this potentially favorable market situation:

- Natural rubber supply will have to keep pace with the expected growth in demand for the synthetic replica isoprenic rubber, and a secure supply will have to be assured.
- Existing successful production technologies will have to be adopted both within and across countries.
- Research, development, market demand for isoprenic rubbers is clearly of the utmost importance—yet it is uncertain that natural rubber producing countries can fulfill it. On the basis of current information on the area under rubber, on projected yields of trees already in the ground, and on expected rates of replanting and new plantings, it appears likely that beyond the early 1980s natural rubber supply will grow at rates below potential market neeeds. Even on the basis of relatively conservative assumptions concerning the growth of demand for isoprenic rubber outside the centrally planned economies and a relatively optimistic assessment of the likely growth of natural rubber supply from existing plantings and from plantings scheduled to come into production, there is likely to be a gap betweeen supply and demanded by the end of the 1980s.

If this gap is not filled by increased supplies of natural rubber, it will probably be met by synthetic polyisoprene. Synthetic polyisoprene producers outside the centrally planducers outside the centrally planned economies have spare capacities and, more important, much shorter investment lags. Since their production can be increased more rapidly, their investment risks are lower. Yet analysis shows quite clearly that natural rubber producers have a substantial competitive cost advantage over polyisoprene (at least under known production technologies) and that, with its technical and economic potential, natural rubber can fill the potential demand gap for isoprenic rubber in the late 1980s.

Enough capital from public and private sources should be available to expand the world production of natural rubber. The technology is not only available but also reasonably well proven. Land for new planting and replanting is plentiful in countries such as Indonesia and Thailand and, to a lesser extent, Malaysia, Brazil, the People's Republic of China, India the Philippines and West Africa also offer scope for new and higher production of natural rubber. Even with current acreage, supply can be increased considerably by speeding up current replanting and using higher yielding varieties of trees. Chemical stimultants can also increase output rates from existing old trees.

Expanding output to meet market needs will involve, over the next 25 years, substantial changes in the country distribution of natural rubber production. The relative importance of Indonesia and Thailand, where new land and labor are more abundant than in Malaysia, will probably increase. In the long term, the People's Republic of China, and eventually Brazil, could become major natural rubber producers. The modes of production may also change substantially, with single smallholders becoming less important at the expense of cooperative types of smalholding organizations, offering members common infrastructural supprt in both the production and the processing of the rubber latex and sharing the ownership of the productive unit. There are strong economic and technical reasons—as well as examples f success—for this type of organization. Geographically, however, the location of the industry will not change much, with Asia accounting for most of the world output.

The possibility of expanding natural rubber production will also offer unique employment opportunities in agriculture to countries having a large and underemployed labor force. It also offers scope for tangible and sustained productivity growth. Expected future price and productivity trends should leave ample room for increasing real returns to producers.

Natural rubber producing countries have shown willingness to cooperate with each other, to share technological advances, and to further research. In October 1979 they also entered into a new agreement with consuming countries to stabilize market prices. The new International Natural Rubber Agreement that came into effect in 1980 foresees the use of a fairly large buffer stock to keep market prices from exceeding a predetermined, but flexible, band of fluctuation. If it is successful, market stabilization will make natural rubber supply more secure and reduce the volatility of the price of natural rubber for its users. Together with sound policies concerning production and exports, the Agreement can give added impetus to the resurgence of the natural rubber industry. The market conditions for a better future for natural rubber seeem to be in place: it is up to the producers to take advantage of this opportunity.

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