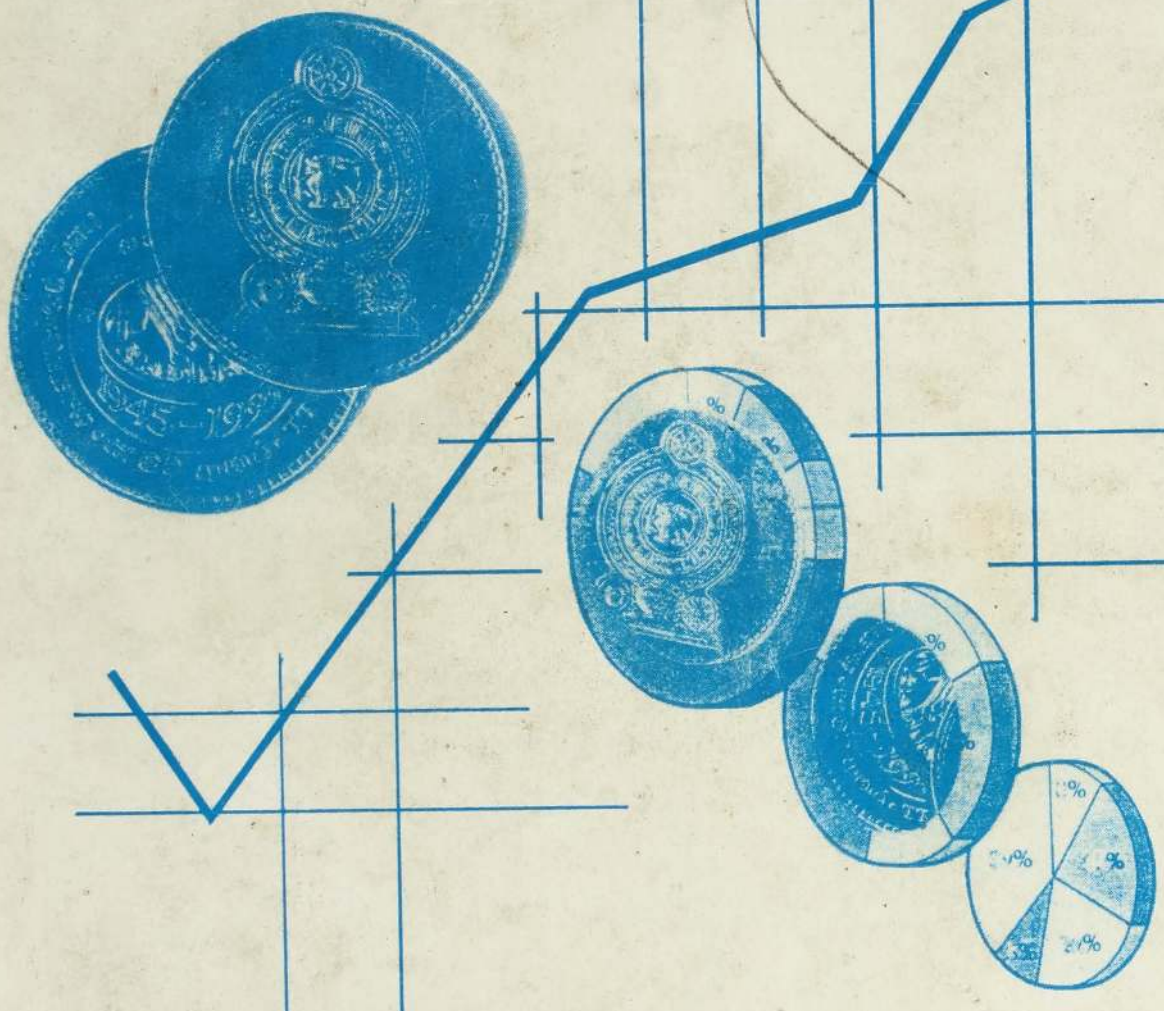


THE ECONOMY OF SRI LANKA IN THE LIBERALISED PHASE



S. S. Colombage

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The Economy of Sri Lanka in the Liberalised Phase

This study analyses the economic performance in Sri Lanka during the period since the adoption of economic liberalisation policies in 1977. Far-reaching economic reforms and structural adjustments have been introduced in Sri Lanka during this period. These policies were based on a market oriented growth strategy aimed at eliminating state controls and inducing private sector economic activities. The key elements of these policies were the removal of foreign trade and exchange controls, removal of price controls, privatisation of state-owned enterprises and liberalisation of the financial sector. This study attempts to evaluate the response of the economy to the policy reforms.

Sri Lanka's efforts to achieve a higher growth path through structural reforms and liberalisation were somewhat hampered by civil disturbances and macroeconomic imbalances. Early action is necessary to correct these imbalances so as to continue the liberalisation process and to overcome the economic problems.

The book is presented in four Parts. Part I covers Chapters on macroeconomic policies and trends. Part II is on production, employment, wages and prices. Part III is on domestic and international finance. Finally, Part IV presents conclusion of the study.



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Author: S. S. Colombage

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The opinions expressed in this study are those of the author and they do not necessarily reflect the views of the Central Bank of Sri Lanka where he is employed.

PREFACE

By introducing economic liberalisation and structural reforms way back in 1977, Sri Lanka pioneered the phasing out of controlled economic regimes in the South Asian region. Since then stringent administrative controls relating to foreign trade and exchange systems, domestic trade and financial sector have been gradually eliminated so as to allow the market forces to determine prices and resource allocation. This study focuses on the implications of these policy reforms for the economy.

With a view to assess the economic liberalisation efforts implemented in Sri Lanka for over one and a half decades, the Friedrich Ebert Stiftung, Colombo Office encouraged me to undertake the present project. Accordingly, Dr. Reinhold Plate former Resident Representative of FES in Sri Lanka (1990-93) agreed to sponsor this study. Dr. Beate Bartoldus who succeeded Dr. Plate as Resident Representative in December 1993 continued to extend her support to complete and print the study. This study was carried out during the period from July 1993 to December 1994. I am grateful to Dr. Beate Bartoldus, Dr. Reinhold Plate and to FES for giving me the opportunity to do this study.

I am also indebted to Dr. D. Wesumperuma who painstakingly edited the book.

Dr. S. S. Colombage

PREFACE

By introducing economic liberalisation and structural reforms way back in 1977, Sri Lanka pioneered the opening up of controlled economic regimes in the South Asian region. Since then, structural administrative controls relating to foreign trade and exchange systems, domestic trade and financial sector have been gradually eliminated so as to allow the market forces to determine prices and resource allocation. This study focuses on the implications of these policy reforms for the economy.

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Dr. S. S. Colombage

FOREWORD

The year 1977 marked a major turning point in the economic history of Sri Lanka. From a dominant policy stance of direct state intervention in production and distribution, the new government in that year adopted a major policy change designed to reduce state control, encourage private investment and enterprise, and generally allowed market forces to bear on the economy. A comprehensive trade and exchange control liberalisation programme was implemented. In doing so, Sri Lanka stood as one of the earliest among the developing countries to bring about rapid economic liberalisation. Further liberalisation of the economy took place since 1989.

By the middle of the 1990s, however, Sri Lanka was clearly looking for critical review of the impact of these policy changes, especially due to the new socio-economic issues and concerns which were emerging consequent to rapid liberalisation of the economy.

The Friedrich Ebert Stiftung, committed as it is to the concepts and values of social democracy, and active with social partners in Sri Lanka since the 1960s, responded to this felt need by initiating a process of discussion, dialogue and study among policy makers, researchers, trade unionists, students and other groups of community activists on the subject of Sri Lanka's experiences in the field of economic reforms and performance in the liberalised phase. One outcome of this initiative, was the sponsorship and the publication of two studies, namely, the present study of Dr.S.S. Colombage on *The Economy of Sri Lanka in the Liberalised Phase* and the earlier publication titled *Economic Liberalisation in Sri Lanka* authored by Dr.V. Kanesalingam.

Both studies were sponsored and published by the Friedrich Ebert Stiftung in the fervent belief that these works will be pertinent and useful to Sri Lanka, her neighbours in South Asia as well as the other countries in the developing world, especially as Sri Lanka was the first country in South Asia to launch a conspicuous programme of economic liberalisation.

Beate Bartoldus
Resident Representative
Friedrich Ebert Stiftung

Colombo. May 1996

The year 1977 marked a significant event in the economic history of India. From a liberalized policy stance, which was adopted in 1956, the government in that year adopted a new policy, change in the state control, and a shift in the economic structure, and generally allowed market forces to operate in the economy. This was a major step towards the liberalization of the economy. The year 1977 also marked the beginning of the economic liberalization process in India. Since 1982

In the middle of the 1990s, however, the liberalization process was clearly evident. A review of the impact of the policy changes, especially during the 1990s, has shown that the economic growth and development have been significant. The liberalization of the economy

The Economic Policy Group, constituted as it is to the economic and financial liberalization, and active with several members in India, since the 1990s, has played a significant role in the process of liberalization. Economic and steady growth among policy makers, researchers, and students and other groups of community members on the subject of the liberalization. In the field of economic reform and performance in the liberalized phase. One of the main objectives of the liberalization was the economic and the introduction of new studies, namely, the present study in the 1990s. The objective of the study is to analyze the liberalization in India, and the impact of the liberalization on the economic growth and development of India. Dr. V. K. Rajwade

These studies were sponsored and published by the Economic Policy Group in the Government of India. These works will be instrumental in the liberalization process in South Asia as well as the other countries in the developing world, especially as the liberalization process in South Asia is a major component of economic liberalization.

Dr. V. K. Rajwade
Economic Policy Group
Government of India

October 1996

CHAPTER 1

INTRODUCTION

Far-reaching economic reforms were introduced in Sri Lanka in 1977 to eliminate state controls and thereby to implement a market-oriented growth strategy. The main elements of this package were the removal of foreign trade and exchange controls, removal of price controls, privatisation of state-owned enterprises and liberalisation of the financial sector. These policies have been intensified over the years with the assistance of the International Monetary Fund and the World Bank through their structural adjustment facilities.

The basic objective of this study is to analyse the economic performance in Sri Lanka after the liberalisation of the economy. The literature on the experience of Sri Lanka during the post-liberalisation period is rather limited. The available writings are limited either to analyse macroeconomic trends or sectoral performance. But this study is intended to analyse both these aspects and thus to focus on macroeconomic imbalances and sectoral constraints. Therefore, it is expected that this study will be useful to researchers, policy-makers, students and the general public.

1.1 Overview

Traditionally, the production structure of Sri Lanka had been dominated by agriculture while other activities such as factory industry, banking and trade were less prominent. Over the years, particularly after the economic liberalisation in 1977, this patterns has changed. Prior to the liberalisation, agriculture accounted for about 30 per cent of the GDP and it has now dropped to about 23 per cent. The share of factory industry has increased from 10 per cent to 15 per cent. Similarly, the proportion of economic services such as domestic and foreign trade has risen from 20 per cent in the pre-liberalisation period to 26 per cent.

In the agriculture sector, the major growing sub-sectors are paddy, subsidiary food crops and export crops. The plantations and fisheries showed a downfall. As regards the manufacturing sector, factory industry mainly the export-oriented ventures, achieved high growth mainly due to the substantial incentives granted by the Government to such industries. Reflecting the growing tendency towards self-employment, small industries have expanded in recent years. In the case of economic

and social infrastructure, the main growing activities include electricity, gas and water, transport and communications and mining and quarrying. In economic services faster growth was reflected in both domestic and foreign trade transactions.

Overall, the economy grew by about 5.4 per cent annum over the last 15 years. Economic services recorded the highest annual growth rate of 6.8 per cent. Manufacturing and construction rose by 5.8 per cent, economic and social infrastructure by 5.3 per cent and agriculture by 3.8 per cent.

Domestic investment is about 24 per cent of GDP as against the domestic savings ratio of 15 per cent; the balance 8 per cent is financed through foreign resources in the form of loans and outright grants. The Government budget deficit is about 7 per cent of GDP. The major exports are garments and other industrial products, tea, rubber, coconuts and minor crop products. The trade deficit is about 10 per cent of the GDP. The impact of the trade imbalance on the current account of the balance of payments has been partly offset by tourist earnings and inward remittances. The current account deficit was about 4 per cent of GDP.

Sri Lanka has a relatively superior labour force in terms of educational levels due to the free education system. Optimal utilization of the labour force is important from the viewpoint of production growth as well as social welfare.

About one half of the total employment is generated in the agriculture sector. Other main employment generating sectors are manufacturing (13 per cent), services (13 per cent), trade (10 per cent) and construction (6 per cent).

Price changes of the country are officially measured in terms of the consumer price index compiled by the Census and Statistics Department. However, it has limitations mainly owing to the outdated commodity weights. Prior to the liberalisation, extensive price controls were in operation and essential goods were supplied at subsidized prices. That system led to commodity shortages and black markets. Following the liberalisation, such controls have been gradually removed and subsidies were eliminated. Thus, domestic prices are now left to be determined by market forces. But undue inflation is prevented by appropriate stabilisation policies.

Wages in Sri Lanka are determined by various factors. The public sector wages are revised by the Government on the basis of the recommendations of the Pay Commissions or through Cabinet directives. Wages in the private sector are influenced by different mechanisms including Wages Boards, Remuneration Tribunals, collective and individual bargaining and unilateral employment decisions. Wage

determination in the Free Trade Zones is subject to the rules and regulations of the Board of Investment under which labour disputes are minimized.

Measured in terms of the Wage Rate Index for Government Employees, wages in the Government sector during 1985-1990 rose by 68 per cent in nominal terms. However, this was lower than the 80 per cent increase in the consumer price index. Wages in the private sector as indicated by the Wages Board Trades wage indices grew by 83 per cent during 1985-1990.

1.2 Methodology

Data on a large number of socio-economic variables have been collected for the study through different sources. These data are mainly in the fields of aggregate production and income, agriculture, industry, money supply, banking, financial sector, government finance, external finance, labour market, wages and inflation. The main institutional sources for these statistics are Ministry of Agriculture, Ministry of Industries, commercial banks, Central Bank, Labour Department and Department of Census and Statistics. In addition, data have also been collected from other specialized institutions, such as the Tea Board, Rubber Controller's Department, Coconut Development Authority and Board of Investment.

Demographic and labour force data have been collected mainly from periodical population censuses. In addition, reports based on sample surveys are also used. Other main data sources are the Labour Department and Employees' Provident Fund. However, all these data have limitations in using them for the compilation of employment statistics.

Since this study is intended to address a larger audience, the analysis was carried out on a non-technical basis providing factual information. However, every attempt was made to quantify the findings of the study and to provide useful statistical parameters.

1.3 Framework of the Study

The Book is divided into 4 parts. Part I consists of Chapters on macroeconomic policies and trends. Part II is on production, employment, wages and prices. Part III is on domestic and international finance. Part IV presents conclusions of the study.

The Book consists of 15 Chapters. Chapters 2 to 4 present an evaluation of the macroeconomic strategies and trends adopted in the pre- and post-liberalisation

periods. Macroeconomic policies are analysed in Chapter 2. Chapter 3 contains a review of structural reforms and Chapter 4 focuses on macroeconomic trends. Chapter 5 deals with the problems of growth, investment and savings. An analysis of production structures and sectoral growth is contained in Chapter 6. Chapter 7 analyses labour market developments. In Chapter 8 the main focus is on wage determination and trade unions. Chapter 9 examines the problem of inflation. Chapter 10 contains the analysis of monetary policy. The financial system is examined in Chapter 11. Chapter 12 deals with financial deepening and economic progress. In Chapter 13 government fiscal operations are focussed. Chapter 14 analyses trends in foreign finance. The main findings and conclusions of the Study are presented in the final Chapter.

PART I

MACROECONOMIC POLICIES AND TRENDS

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PART I

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CHAPTER 2

MACROECONOMIC POLICIES

2.1 Central Planning and Economic Controls: Pre-1977 Period

During the three decades following Independence, economic strategy of Sri Lanka was based on a series of economic plans implemented by successive governments. The type of policies adopted in these plans differ depending on the socio-economic needs during the period in question and the ideologies of the political parties in power. A major feature of the economic policies adopted since the early sixties until 1977 with the exception of a few years was the heavy dependence on quantitative restrictions on foreign trade and domestic economic activities for stabilisation purposes.

During the first decade following Independence (1948-1959), Sri Lanka initiated several development programmes. A salient feature of these programmes was the emphasis given to promote production activities other than the plantation crops sector, which had been given high priority during the colonial administration. A Six Year Plan was presented for the first time in 1950 outlining the targets of capital investment. During this time a Planning Secretariat was set up on the recommendations of the World Bank to coordinate planning activities.

The second Six Year Plan was begun in 1954 in consultation with the World Bank. The Central Bank's participation was crucial in the meetings with the World Bank Missions in subsequent years. In the development plans, priority continued to be given to agriculture, including irrigation and land development. The balance capital expenditure was allocated among transportation, power, health and education.

The economic strategy adopted under the new administration of 1956 departed from the previous policies. The broad development strategies followed during this period were reflected in the First Interim Report and the Ten Year Plan. These documents identified the basic problems of the economy and stressed the need to raise domestic investment in the sectors of agriculture and industry. The main objectives of the Ten Year Plan presented in 1959 were to raise domestic investment, reduce unemployment and achieve external equilibrium. Unlike the earlier plans, the Ten Year Plan gave high priority to the industrial sector.

By the beginning of the 1960's, the country encountered several economic problems. On the external front, the balance of payments began to deteriorate in the late fifties, mainly due to the faster increase of imports over exports. Inflationary pressures were also beginning to surface in the late fifties due to monetary expansion. The promotion of both export trade and domestic investment was considered essential to overcome these problems. Import restrictions and tight monetary measures were viewed as the most appropriate corrective measures during that period.

The balance of payments deficit had been financed mainly by drawing down external reserves prior to 1961. The reserves went down to substantially low levels by 1960 and therefore, foreign assistance was sought to meet the external deficits after 1961. Drawings were made from the IMF in 1961 and 1962 to prevent further depletion of reserves. In order to curb the balance of payments deficits, severe exchange and trade controls were introduced. Short term "rolling plans" were presented in 1961 and 1963 by the Planning Department. Domestic savings and investment in relation to GDP showed a marginal improvement during 1960-64 as compared with the previous decade. The average annual GDP growth rate moved from 3.1 per cent in 1948-59 to 4.1 per cent in 1960-64.

The adverse impact of the quantitative restrictions on economic activities was felt by 1965. The immediate task of the Government which took over office in that year was to promote economic growth and expand employment opportunities while maintaining a reasonably sound balance of payments position. For this purpose, a larger inflow of capital and intermediate goods was necessary. Since export earnings were not adequate to meet this demand, mobilisation of foreign aid was considered to be inevitable. The need of a more liberal foreign trade regime and a realistic exchange rate was also realized during this period. The planned targets and investment allocations were laid down in the Annual Development Programme 1966-67. Accordingly, the Budget proposals for 1966-67 provided for a 31 per cent increase in investment. For the first time, policy-makers emphasised the need to obtain foreign aid to meet the investment targets.

Several policy measures were taken to promote exports. In order to encourage the minor export crop sector, the Bonus Voucher Scheme was introduced in 1966. Since the exchange rate was found to be unrealistic, the Rupee was devalued by 20 per cent in 1967. As a further incentive to the export sector, a dual exchange rate was introduced in 1968 under the Foreign Exchange Entitlement Certificate (FEEC) Scheme which provided a depreciated exchange rate system for non-traditional exports and non-essential imports. This Scheme was administered by the Central Bank.

Following the change of the Government, trade and exchange controls were reintroduced in the early 1970's. In the meantime, the problems of unemployment and balance of payments deficits became acute. In the background of these problems, the Five Year Plan (1972-76) was presented in 1971. It envisaged a gradual increase in domestic savings and investment over the medium term so as to attain a higher growth rate. The FEEC Scheme continued to be in operation during this period. The Convertible Rupee Account (CRA) Scheme was introduced in 1972 to boost further the minor export sector by granting exporters a share of export earnings in foreign currency. Mobilisation of foreign resources also showed an increase during this period. However, external assistance was maintained at a low level during 1970-77 and therefore, domestic investment was largely financed by domestically generated savings.

2.2 Policy Reforms for Liberalisation: Post-1977 Period

The change of the Government in 1977 marked a turning point in economic policies. The capacity of any economy to grow depends largely on the ability to save and invest. As discussed above, both savings and investment remained at a low level in the earlier period. Private sector savings were at a low level due to limited activities. Government sector savings also did not improve due to increased recurrent expenditure. The savings of public corporations were hampered partly by their inefficiency. The policies that were followed up to 1977 were geared to maintain at the expense of growth. Accordingly, policy-makers preferred to maintain a low economic growth without creating imbalances in the government budget and balance of payments. Various direct administrative controls were imposed to achieve this end. As a result, investment was not much higher than domestic savings.

A different policy strategy was introduced by the Government that came into power in 1977. It was realised that the restrictive policies that were followed during the earlier period constrained domestic economic activities and resulted in a slow growth process. It was necessary to overcome problems such as unemployment, balance of payments difficulties and production shortfalls immediately. As mentioned above, the capital stock was not raised during the previous regime. In order to revitalise the economy, therefore, action was taken to dismantle administrative controls and to encourage private sector production activities.

Domestic production was also constrained by the limited imports of intermediate and investment goods during the period prior to 1977. Stringent import and exchange controls were in operation during that period. This resulted in production shortfalls in both import substituting and export-oriented production sectors. In view

of these adverse repercussions of administrative controls, a policy package was formulated to liberalise and simplify the exchange and trade system in late 1977. The basic strategy of these reforms was to allow the price mechanisms to determine economic activities and to eliminate the influence of import and exchange controls. Accordingly, action was taken to remove the prior licensing requirements for a wide range of imports and service payments. Under these reforms, prior licensing was restricted only to certain items that had a bearing on essential consumption and national security. The trade liberalisation that was started in 1977 continued to be widened in subsequent years by the removal of more goods from the prior licensing requirement.

The export-oriented growth strategy that was followed after 1977 called for the steady maintenance of export competitiveness, mainly through a managed floating exchange rate system. Until November 1977, a dual fixed exchange rate system had been in operation in Sri Lanka. Under the floating exchange rate system that has been adopted since then, the Central Bank intervenes in the determination of the exchange rate on a daily basis, taking into account various factors including the demand and supply situations in the foreign exchange market and domestic and foreign inflation. In this context, the exchange rate is largely determined by market forces and a primary concern of the Central Bank is to prevent any abrupt fluctuations in the exchange rate that could adversely affect the export competitiveness of the country.

The package of policy reforms introduced in late 1977 was supported by a one-year standby arrangement of the IMF. The package included (a) dismantling of price, import, and foreign exchange controls; (b) commitment to remove government subsidies; (c) unification of the exchange rate at a depreciated level; (d) more flexibility in exchange rate management; and (e) interest rate reforms to foster private savings and investments.

A major objective of policies followed since 1977 was to raise domestic investment to a substantial level so as to revitalise the stagnant economy. For this purpose, it was necessary to raise the capital expenditure of the public sector. It was also realised that there was a need to allow the private sector to participate in economic activities more liberally unlike in the previous period. Accordingly, the private sector was expected to engage extensively in the production of goods and services and government participation was to be confined to providing the necessary economic infrastructure to facilitate the production activities. This strategy was reflected in the Public Investment documents published since 1977. The bulk of public investment was allocated to upgrade the infrastructure of the country. Investment targets envisaged for both public and private sectors were relatively high,

as against the low level of domestic savings.

Sri Lanka entered into an Extended Fund Facility (EFF) with the IMF for the period 1979-81. The main objectives of the programme were (a) to reduce unemployment; (b) to maintain an average annual rate of GDP growth of 6 per cent; and (c) to contain inflation. It was envisaged to maintain the external current account deficit at about 10 per cent of GDP and to contain inflation to about 10 per cent per year.

Under this programme, it was expected to rehabilitate the tree crop sector and to provide attractive production incentives to the entire agricultural sector. Action was also to be taken to further reduce price distortions relating to internationally traded goods and to maintain a flexible exchange rate system. Domestic investment was to be raised to higher levels. Specifically, private investment was encouraged by liberal economic climate, tax incentives and attractive foreign investment climate. The structural adjustment objectives were to be achieved while maintaining a moderate demand management stance.

The IMF approved a request by Sri Lanka for loans totalling SDR 336 million (about \$ 455 million) for the period 1991-94 under the IMF's Enhanced Structural Adjustment Facility (ESAF) to support the Government's economic and financial programme. (The ESAF is the IMF's concessional lending window for assisting its poorest members that are undertaking structural economic programmes to substantially strengthen their balance of payments position in a sustainable manner. The loans carry an annual interest rate of 0.5 per cent, and are repayable over 10 years, with a 5-year grace period).

The Government's medium-term strategy, covering the period 1991-94 supported under the ESAF, sought to maintain high rates of economic growth, reduce inflation and unemployment, and maintain a viable external payments position with greater reliance on foreign investment and, eventually, a reduced dependence on concessional assistance. The programme was designed to accelerate the process of industrialization by expanding the areas in which domestic and foreign private sector interests will be encouraged to operate, while reducing the public sector's involvement in the economy in both production and trading regulatory functions. Public investment was geared to develop infrastructure. Agricultural activities were also to be rehabilitated in order to release additional domestic resources.

Within this framework, a major objective was to restructure the government budget. This was based on holding current expenditure growth below that of nominal GDP, avoiding further cuts in capital expenditures, and broadening the revenue base

and improving tax administration. At the same time, the pace of privatisation was accelerated considerably and measures were adopted to minimise government regulation of industry, attract foreign investment, and increase industrial competitiveness through further liberalisation of the trade payments system.

In order to improve the functioning of the financial sector and to promote the efficient allocation of domestic savings, the commercial banking system was to be overhauled and the Central Bank's supervisory responsibilities was to be strengthened. It was also envisaged to ensure that interest rates more accurately reflect market conditions.

The objectives of the Government's economic programme for 1991-92 were to maintain real annual economic growth at 5-6 per cent, continue to reduce inflation, limit the current account balance of payments deficit, and increase official reserves. To achieve these goals, the authorities implemented a series of fiscal and monetary measures to raise additional revenues, contain government spending, limit credit to public corporations, and enhance market-based determination of interest rates.



STRUCTURAL REFORMS

The macroeconomic policies implemented in Sri Lanka since 1977 were characterised by an intensification of the structural adjustment efforts. These policies were an outcome of the need to deal with structural problems and financial imbalances in the economy. The basic objective of the structural adjustment reforms was to achieve a satisfactory and sustainable rate of economic growth, reduce inflation and attain a viable balance of payments situation.

In designing the programme, achievement of domestic and external financial stability was considered as a prerequisite for a sustainable economic growth. On the domestic front, high levels of inflation resulting from excessive demand pressures would discourage savings and investments leading to a drop in economic growth. On the external front, continuous deficits in the balance of payments may reduce foreign exchange reserves and as a result, it would be necessary to impose import restrictions. Such restrictions would curtail import of raw materials and capital equipment, thus leading to a setback in economic growth.

The structural reforms introduced in Sri Lanka included domestic and external liberalisation measures, financial sector reforms, fiscal policy adjustments, and public sector restructuring programmes. The process of liberalisation was accelerated since 1989. Relaxation of exchange control regulations was a significant step towards liberalisation during this period. In the financial sector far-reaching reforms were implemented so as to enhance the supply of financial resources to meet the increasing investment requirements. Freeing of interest rates from administrative controls, introduction of the secondary market for Treasury Bills and the promotion of the share market are the main elements of the financial reforms. In the case of fiscal operations, action was taken to curtail non-productive public spending and to rationalise the government revenue structure. A privatisation programme was implemented to transfer state-owned enterprises to the private sector and thereby to improve their efficiency.

3.1 Exchange Liberalisation

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The liberalisation process that began in 1977 accelerated after 1989 and paved

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the way to reach full convertibility on the Current Account in 1994. Accordingly, authorised dealers are now permitted to release foreign exchange without restriction for all current account (non-capital) transactions, exercising their judgment and discretion after satisfying themselves with the *bona fide* of the requests.

Certain relaxations have been made with respect to capital account transactions. In the case of portfolio investments in the share market, approved Country and Regional Funds and individuals resident outside Sri Lanka are permitted to invest in upto 40 per cent of the issued equity of listed public companies. These investment flows and related repatriation of dividends are to be channeled through Share Investment External Rupee Accounts (SIERA) in commercial banks with automatic exchange control authorisation of such transactions. A number of tax incentives have also been granted to foreign portfolio investors.

As regards direct foreign investment, the Board of Investment (BOI) is responsible for the approval and facilitation of such investment throughout the country except portfolio investment and certain specific investments that are regulated by other Statutory Agencies.

The BOI has been authorised to grant automatic investment approvals in most sectors upto 100 per cent equity participation in such ventures. A Resident Guest Scheme has been introduced to allow foreigners to obtain 5-year Residence Permits in Sri Lanka upon depositing a specified minimum amount. The permits would be converted to citizenships at the end of 5 years at the discretion of the Government.

3.2 Evolution of Trade and Exchange Control Regimes and Liberalisation

The system of import and exchange controls had been a major policy instrument that was used to contain external disequilibrium since the early sixties up to the latter part of the seventies. Under this system, quantitative restrictions (QRs) were imposed on external payments with respect to imports of goods and services. The impact of these restrictive foreign exchange regimes was felt on the structure and performance of the economy considerably. Therefore, it would be useful to discuss the evolution of these regimes in this section before we analyse the external payments problems experienced by the country.

A method suggested by Bhagwati (1978) and Krueger (1978) is used here to identify the different phases of import and exchange controls. Major features of these phases are summarised below:

Phase I - The government imposes and intensifies quantitative restrictions in order to reduce an unsustainable deficit in the balance of payments. However, there is no protectionist intention at this stage. Imports are usually controlled by adopting a rule of thumb, eg., by imposing a limit on this year's imports as a proportion of previous year's levels.

Phase II - The government continues to rely on quantitative restrictions during this phase. But at this stage, regulations and procedures relating to quantitative restrictions are laid down in detail. Regulations are imposed to differentiate imports on the basis of some criterion. Priorities are generally given to those imports that are considered to be essentials such as food items and capital and intermediate goods required for approved production ventures. Another significant feature of this phase is the use of various price measures in order to offset some adverse implications of the system. These measures include increase tariffs, import surcharges, export rebates and special tourist exchange rates.

Phase III - This phase marks the beginning of the removal of quantitative restrictions. A major devaluation is a common feature at this juncture and it is accompanied by a simplification of exchange and trade controls. Some of the price measures introduced in Phase II are also removed in this phase.

Phase IV - If changes in Phase II lead to adjustments in the economy, the country is said to enter Phase IV. Otherwise, it will re-enter Phase II. Reliance on quantitative restrictions is reduced considerably in this phase. It also involves a gradual relaxation of quantitative restrictions. This will bring about a fall in monopoly profits of importers, therefore, the domestic prices of tradables tend to converge to world prices.

Phase V - The exchange regime is fully liberalised and there exists full convertibility of the current account.

The experience of Sri Lanka since the Post-World War period has been characterised by restrictive trade and exchange systems as well as liberalisation attempts. Following the above approach, this period can be delineated into the following phases:

Period	Phase
1945 to September 1949	I
September 1949 to July 1951	III
July 1951 to August 1957	IV
August 1957 to August 1960	I
August 1960 to November 1967	II
November 1967 to May. 1968	III
May 1968 to August 1970	IV
August 1970 to October 1970	I
October 1970 to November 1977	II
November 1977 to June 1978	III
June 1978 to March 1994	IV
March 1994 to date	V

1945 to September 1949 (Phase I)

The use of exchange controls was first introduced in Sri Lanka as an emergency measure with the outbreak of war in 1939. The currency of Sri Lanka at that time was based on a Sterling exchange standard and, therefore, external payments of the country were largely linked with the Sterling Area. Following the outbreak of the war, transactions between the Sterling Area and the rest of the world became more restrictive due to a shortage of several currencies. Therefore, exchange control regulations were introduced to control receipts from and to outside the area, particularly countries whose currencies were regarded as hard, the most important currency being the U.S. dollar. These restrictions continued to be in force during the immediate Post-War period.

September 1949 to July 1951 (Phase III)

Following the devaluation of the Pound Sterling, the Sri Lanka Rupee was devalued in September 1949. There was an improvement in the balance of payments, after the devaluation and, therefore, steps were taken to relax quantitative restrictions. Certain exchange control regulations on outward remittances were relaxed in 1950. In January 1951, certain important commodities were permitted to be imported freely from all sources except Japan under Open General Licences (OGL).

July 1951 to August 1957 (Phase IV)

Imports were further liberalised in May and July 1951. Several exchange control regulations on imports were also relaxed. Restrictions on outward remittances to countries within the Sterling Area for purposes such as family maintenance, education, travel and charities were considerably liberalised in September 1951. Thus, Sri Lanka experienced a fairly liberal regime in this period. No restrictions on current account transactions were imposed during this period. All imports, except a few items such as essential goods (mainly food) and firearms, were permitted to be imported under OGL without obtaining individual licences.

August 1957 to August 1960 (Phase I)

The external payments position began to weaken in 1957 and it was necessary to impose restrictions on external payments. A number of consumer goods including textiles, footwear, alcohol and electrical appliances were brought under individual licensing requirements.

August 1960 to November 1967 (Phase II)

Major features of this phase were the introduction of price instruments, price intervention and intensification of quantitative restrictions. Customs duties on a variety of imports were raised in order to reduce the premiums accrued by import licence holders who monopolised import trade under restrictive regimes. Provision of protection to import substituting industries was another objective of this tariff revision. Also, a customs surcharge was imposed on several imports. On the export side, a rebate on income tax was granted to specified manufactured products. In addition, under a Bonus Voucher Scheme introduced in 1966 exporters of certain non-traditional exports were made qualified to receive import licences for a value equivalent to a specified proportion of their export earnings enabling them to import trade quota items.

Despite the introduction of the above price instruments, the phase was characterised by continued reliance on quantitative restrictions. In fact, the QRs introduced in the previous phase were intensified and organised in this phase. The Foreign Exchange Budget Committee was established for allocation of foreign exchange resources among different categories of imports.

November 1967 to May 1968 (Phase III)

For the first time after 1949, the Rupee was devalued by 20 per cent in 1967.

This marked the beginning of Phase III. The devaluation was followed by an introduction of a multiple exchange rate system in May 1968 to bring about a further depreciation of the currency with respect to certain external transactions. This was the first attempt made by Sri Lanka to use the exchange rate as an instrument to influence the balance of payments.

May 1968 to August 1970 (Phase IV)

The authorities realized that the QRs and exchange control that had been adopted in the previous political regime had adverse implications such as corruption, black market in foreign exchange, under-utilization of industrial capacity and import bias. In parallel with the adoption of the multiple exchange rate system, therefore, measures were taken to relax the rigid trade and exchange restrictions which had been in operation for a decade. However, the relaxation was limited to certain goods and services and thus, this period enjoyed only a partial liberalisation.

August 1970 to October 1970 (Phase I)

The Government which came into power in August 1970 took action to reverse the external policies. The OGL system was abolished and all imports were brought under a system of trade quotas. The Foreign Exchange Budget Committee was reconstituted to administer the quota system. However, the multiple exchange rate system remained intact until 1977.

October 1970 to November 1977 (Phase II)

Introduction of price instruments was a major feature of this phase. In October 1970, steps were taken to rationalise the import duty structure and accordingly, import tariffs were simplified into six bands. The purpose of this simplification was to provide tariff concessions to essential consumer goods and certain intermediate and capital goods as well as to grant tariff protection for import substituting industries. Certain price measures were also taken to offset the adverse impact of both QRs and a fixed exchange rate system on the export sector. The Convertible Rupee Accounts (CRA) Scheme was introduced in 1973 to grant import entitlement facilities to non-traditional exporters. Tea exports were exempted from advalorem sales tax and a guaranteed price was fixed for rubber exports.

November 1977 to June 1978 (Phase III)

The development strategy of the government which came to office in 1977 was

based on an outward looking strategy. As a first step, the FEEC Scheme was abolished and the exchange rate was unified at a depreciated level. The CRA Scheme was also withdrawn. Measures were also taken to revise the export and import duty structure entirely. QRs and exchange control restrictions on most goods and services were abolished. However, liberalisation process slowed down due to macroeconomic adjustment problems.

June 1978 to March 1994 (phase IV)

The liberalisation process was accelerated during this period. A number of restrictions on imports, travel abroad and foreign education were relaxed. In order to attract foreign capital, restrictions on foreign participation at the Colombo Stock Exchange by foreigners were relaxed. Extended facilities were also granted to foreigners investing under the B.O.I. (earlier known as Greater Colombo Economic Commission).

March 1994 to date (Phase V)

Following the removal of Exchange Control restrictions on Current Account transactions, Sri Lanka accepted Article VIII Status of the IMF in March 1994. Accordingly, Sri Lanka agreed not to impose any restrictions on import and export of goods and services.

3.3 Financial Sector Reforms

It is widely accepted that trade and foreign exchange liberalisation alone is insufficient to achieve improved economic performance and export-led growth. Other macroeconomic policies that inhibit domestic supply also need to be reformulated. Among these policies, those relating to financial institutions, financial markets and monetary sector are prominent. The usual restrictive monetary policies consisting of direct credit controls and rigid interest rates lead to distortions in the financial sector and thus, they discourage savings and investments. Therefore, it is necessary to liberalise the financial sector in order to promote efficient allocation of financial resources in line with the incentives brought about by trade reforms.

In view of the above considerations, many countries have adopted policies to reform the financial sector. The basic objectives of these policies are to improve the monetary control system and to facilitate the mobilisation and allocation of resources. These policies have been supported by the Structural Adjustment Facility (SAF) and Extended Structural Adjustment Facility (ESAF) programmes of the

IMF. The main thrust of these programmes is to foster economic growth by using an efficient banking and financial system. Financial sector reforms become important at this juncture. The financial sector reforms have been designed to address three broad issues - (1) The need to formulate monetary policies to help achieving macroeconomic objectives by means of increased reliance on indirect rather than direct controls; (2) Institutional reforms to improve the efficiency of the financial systems; and (3) The rationale of level and structure of interest rates.

In Sri Lanka, far-reaching financial reforms have been adopted in recent years. Major monetary policy instruments that had been adopted prior to the reforms were the low interest rate ceilings and direct credit controls. These policies led to a segmentation of money and capital market; an official segment consisting of formal financial institutions (mainly banks) and an unregulated market segment consisting of informal credit institutions and private money lenders.

In the informal market, money lenders levied high interest rates from borrowers. In contrast, in the official segment interest rates were kept at low levels by means of interest rate ceilings, subsidised credit allocations and high reserve ratios. Meanwhile, the banks found it difficult to attract deposits due to low interest rates and therefore, they had to ration their credit, giving priority to large scale established enterprises. Since the small scale borrowers were neglected by official institutions in that system, they depended on the informal segment ("curb" market) at high cost. These characteristics were somewhat similar to those implied by the phenomenon of "financial repression". This situation led to discourage savings and investments and thereby tended to slowdown economic growth.

In an effort to overcome the financial repression, the Central Bank has taken steps to liberalise the interest rate structure and to reduce the dependence on direct credit controls. Accordingly, open market operations in short term securities have been increasingly used in recent years to control liquidity in the market and to influence the level of interest rates.

Interest rate liberalisation has been a key element in the monetary policy reforms. Since interest rates were not allowed to adjust for domestic inflation, real interest rates remained negative prior to the pre-reform period. Following the interest rate reforms adopted since 1977, the real interest rates became positive, thus contributing to promote financial savings and investments. Using broad money supply as a proxy, financial savings as percentage of GDP rose to 31 per cent by 1992 from a level of around 21 per cent in 1976.

The new monetary measures of the Central Bank are tied up with the objective of the development of money and government securities markets. In this context, the monetary authorities have made significant progress towards establishing a regular Treasury Bill market. The introduction of a secondary market for Treasury Bills was a major step that contributed to popularise the Bills. Qualified financial institutions are now permitted to function as primary dealers of Treasury Bills and this has tended to promote the secondary market and to increase its liquidity. As a consequence of these developments, the Treasury Bill holdings of the Central Bank have declined sharply from 99 per cent in 1983 to 30 per cent by 1992.

The financial sector reforms adopted in Sri Lanka also encouraged competition in the banking system. It was observed that monopolistic practices that prevailed prior to reforms created inefficiencies in the domestic banking sector and resulted in high intermediation cost of banking services. Therefore, action was taken to eliminate restrictions on entry into the banking system. As a result, some new domestic banks have emerged and several foreign banks have established branches here. Restructuring of state-owned banks so as to improve their efficiency is also part of the financial reform package in Sri Lanka.

Recognising the importance of capital mobilisation in the context of the increasing role of private sector, the authorities have accorded priority to the development of the capital market. The objective of this policy is to increase the number of new listings and the volume of capital raised through the Colombo Stock Exchange.

3.4 Fiscal Reforms

Fiscal reforms were an integral part of the overall adjustment process. A main objective of these reforms was to reduce the imbalances in government finance, thus easing the task of monetary policy and contributing to a reduction in the external current account deficits. It was also envisaged to direct fiscal policies from a regulated economy to a market-oriented framework and thereby to promote private investment.

Under the medium term framework adopted during 1979-81, action was taken to reduce fiscal subsidies and to divert substantial amount of resources to lead development projects. Accordingly, subsidies on wheat flour, fertilizer, milk products and petroleum products were reduced. In addition, the number of persons qualifying for the income supplement scheme was curtailed. It was anticipated that phasing out of subsidies would help to remove price distortions.

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SPECIAL COLLECTION

Following a comprehensive review of tax policy and its administration in 1978, a major tax reform was adopted. In order to induce domestic and foreign investments, a series of tax concessions were introduced. Measures were also taken to simplify the taxation of individuals, companies, institutions and wealth. Also, taxation of agricultural exports was restructured to maintain their competitiveness.

3.4 Fiscal Balance

Fiscal balance is a major part of the overall economic framework. The objective of fiscal policy is to ensure the stability of the economy and to maintain a high level of employment and production. It was also intended to ensure that the government account deficit is kept within limits and to ensure that the government is able to finance its investment programme.

The government has a long history of budget deficits. In 1978, the government budget deficit was Rs. 1,000 crore. This was due to a number of reasons, including the increase in the price of oil and the increase in the price of food grains. The government has since taken a number of measures to reduce the budget deficit, including the introduction of a new tax system and the reduction of government expenditure.

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CHAPTER 4

MACROECONOMIC TRENDS

The economy responded impressively in the initial years following the liberalisation. By 1978 private sector recovered considerably and this brought about a rise in economic activity. As a result, the real GDP grew by 8.8 per cent in 1978, 6.4 per cent in 1979 and 5.6 per cent in 1980. A major factor that contributed to accelerate economic growth was the upward shift in investment. Gross Domestic Investment as a ratio of GDP increased rapidly from 14 per cent in 1977 to 20 per cent in 1978 and to a peak level of 34 per cent in 1980. In contrast, domestic savings as a ratio of GDP fell down from 18 per cent in 1977 to 11 per cent in 1980. Thus, excess of domestic investment over domestic savings (domestic resource gap) was bridged by net imports of goods and non-factor services known as foreign savings. Net imports as a ratio of GDP increased from 14 per cent in 1977 to 23 per cent in 1980. This meant that it was necessary to maintain increasing deficits in the balance of payments to generate foreign resources in the form of foreign loans and grants to meet domestic investment requirements. The current account of the balance of payments moved from a surplus equivalent to 0.7 per cent of GDP in 1977 to a deficit of 0.7 per cent in 1979 and to 16 per cent in 1980.

4.1 Post-Liberalisation Period

In addition to the high levels of investments, a rise in real consumption following the liberalisation also contributed to the rising imports and the worsening of balance of payments. This situation was further aggravated by increases in import prices and a decline in prices for traditional exports.

Another major setback to the adjustment effort was the substantial deterioration in government finance. Both current and capital expenditure rose and, as a result, the budget deficit expanded in spite of a rise in revenue. The current account deficit, which was about 8 per cent in 1977, went up to around 17 per cent in 1978 and 1979 and rose to a peak level of 25 per cent in 1980. The budget deficit was partly financed by expansionary sources and this led to a considerable increase in net domestic assets of the banking system. As a result, a rapid monetary expansion occurred during this period; the broad money supply increased by 38 per cent in 1979 and by 32 per cent in 1980.

Thus, the economy was faced with a severe macroeconomic imbalance by the beginning of the 1980's. In order to deal with this problem, a comprehensive demand management policy package was adopted in 1981. Accordingly, public expenditure was reduced by 1 per cent in current prices from the 1980 level. The administered prices of several essentials (wheat flour, petroleum products, fertilizer, etc.) were increased. In addition, monetary measures were introduced to tighten bank credit to the private sector and raise interest rates. The lump-sum depreciation allowance for private investment was withdrawn. The adjustment effort was to be supported by a more flexible exchange rate policy.

4.2 Impact of Adjustment Efforts

The impact of the adjustment efforts was seen in 1981. The budget deficit was reduced to 18 per cent and the rate of monetary expansion (M2) declined to 23 per cent.

The budget deficit expanded again in 1982 to 20 per cent of GDP and the money supply rose by 31 per cent. The GDP equivalent of external current account deficit also increased to 12 per cent in that year. The macroeconomic instability continued to prevail until about 1985. During the period 1985-87 the rate of inflation remained relatively low with a favourable 1.5 per cent inflation in 1985 and a moderate rise in the subsequent 2 years. This was possible in spite of the considerable budget deficits which were around 15 per cent of GDP.

A structural adjustment programme was implemented in 1988 with the support of the IMF. It was disrupted by the civil disturbances, exacerbated demand pressures (large wage increases and recruitment in the government sector) and elections. Fiscal situation was worsened by new investment plans and the budget deficit rose to 19.5 per cent of GDP. Monetary expansion which was around 10 per cent a year during 1985-88 rose to 16.5 per cent in 1989. The rate of inflation rose to 14 per cent in 1988 and reached 21 per cent by 1990. However, it is encouraging to note that the external current account deficit declined to 4.4 per cent in 1989 and to 3.2 per cent in 1990.

The economy recovered in 1990 with a real GDP growth of 6.2 per cent. The rate of inflation increased to 21.5 per cent in 1990 due to depreciation of the exchange rate, subsidy removals, transport bottlenecks and increase in petroleum and other import prices following the Middle East crisis. The budget deficit was reduced to 13.7 per cent owing to curtailment of capital expenditure. Action was also taken to reduce current expenditures including the elimination of subsidies on fertilizer, rice and flour, the adjustment of petroleum prices to reflect full costs and the rephrasing of the poverty alleviation programme.

Despite the stabilisation measures implemented by the authorities, major macroeconomic imbalances continued to prevail after 1990. The rate of increase of broad money supply which was brought down to 12.5 per cent in 1989 rose to 19 per cent in 1990 and 23 per cent in 1991. This was largely an outcome of the increases in net domestic credit to the private sector and net external assets. The Government Budget deficit was contained to 10 per cent in 1990, but rose to 12 per cent in 1991. The excessive monetary expansion led to accelerate inflation; 21.5 per cent in 1990 and 12.2 per cent in 1991. The external current account deficit increased to 5.4 per cent of GDP in 1991.

Domestic credit to the private sector and net external assets continued to increase in 1992 and had a positive impact on the money supply. But the tight monetary policies helped to contain the monetary expansion at 16 per cent during that year. In consequence, the rate of inflation declined slightly in 1992.

It is encouraging to note that net credit to Government increased only marginally in 1992 and it declined in 1993 reflecting the contribution made by the fiscal authorities towards stabilisation. This was possible through a contraction of the budget deficit to the GDP equivalent of 7.3 per cent in 1992 and 8.1 per cent in 1993. The increase in money supply since 1992 has been largely due to enhanced credit to the private sector and surges in foreign private capital inflows. In line with the high monetary expansion, the general price level continued to rise at about 12 per annum in 1992 and 1993. The external current account deficit, however, was maintained at 4.5 per cent of GDP in 1992 and 3.7 per cent in 1993.

4.3 Lessons for the Future

The post-liberalisation experience of Sri Lanka reveals that the structural adjustment efforts aiming at faster economic growth has been hindered very often by prolonged and significant macroeconomic imbalances. These imbalances had been largely an outcome of enhanced domestic credit to the government or private sectors until around 1991-92. In addition to these effects, an expansionary factor - inflow of foreign private capital - which is rather new to Sri Lanka as well as to many other developing countries emerged in recent years.

Macroeconomic imbalances are usually characterised by high and abrupt inflation and periodic balance of payments crises. The socio-economic repercussions of these imbalances are well known. Inflation weakens the living standards of the masses and discourages savings, and investments. It also has a tendency to misallocate resources. On the external front, the balance of payments deficits lead to

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fluctuations in economic activities and adversely affect long term growth with mounting external debt problems.

In view of the above considerations, economic stabilisation has been accepted as a prerequisite to economic growth and employment creation in developing countries. Generally, stabilisation means maintenance of a low inflation rate and sustainable balance of payments position. In particular, it is important to maintain a more credible stabilisation policy stance to build up private investors' confidence in the domestic economy.

The pressure on the general price level and balance of payments can be partly eased by reducing aggregate demand or total absorption level of the economy. Excessive absorption levels in Sri Lanka as in the case of many developing countries are primarily linked to large government deficits. Fiscal policy, therefore, is a major absorption reducing instrument in these countries. Fiscal policy can be supplemented by contracting monetary policy measures to curb monetary expansion. It may be noted, however, that expenditure reducing strategies in most instances lead to slow down economic activity and thereby to decelerate growth.

Apart from absorption reducing policies, economic stability can also be attained by switching expenditure to more productive sectors. Exchange rates is a major instrument of expenditure switching policy.

A primary cause for macroeconomic imbalances in Sri Lanka was the domestic savings gap which is interrelated with the foreign exchange gap. Due to the low level of domestic savings, Sri Lanka continued to depend on foreign resource inflows. In this context, a decline in foreign aid would slow down growth and would also disturb the liberalisation process. In recent years, Sri Lanka has created an investment climate conducive to foreign investors and thereby attracted considerable private investments.

PART II

PRODUCTION, EMPLOYMENT, WAGES AND PRICES

PAKISTAN

PRODUCTION
EMPLOYMENT

WAGES AND PRICES

CHAPTER 5

GROWTH, SAVINGS AND INVESTMENT

The objective of this Chapter is to assess the impact of the adjustment efforts on the growth path and on the behaviour of savings and investment. The economy remained sluggish in the pre-reform period mainly due to low savings and investments. Following the economic reforms, investments were raised by means of higher reliance on foreign savings, but domestic savings continued to remain low. This means that the country is bound to live with external deficits to meet its investment needs.

5.1 Economic Growth

In real terms, the average annual growth rate of GDP of Sri Lanka was around 4.0 per cent which was below the average for low-income countries (Table 5.1). However, Sri Lanka has performed better in terms of the growth of per capita GDP owing to a deceleration of population growth as compared with all low income countries.

During the period 1961-93, the GDP grew annually by 4.4 per cent. The growth during 1961-70 was marginally higher than the long term growth. In the next decade of 1971-80, there was a setback in the growth performance, particularly during the first half of the decade. A major factor that was responsible for this outcome was the crude oil price increase in 1973 which led to a deterioration of the terms of trade, and tended to decelerate economic growth. In addition, a series of droughts in the periods of 1971-73 and 1975-76 adversely affected paddy and tree crop sub-sectors.

Following the adoption of policy reforms in 1977, the GDP growth accelerated at an annual rate of 6.9 per cent during 1978-80. The economy continued to grow at a pace of 5.2 per cent per annum until 1985. The major growing sectors were agriculture, manufacturing, construction, trade and financial services. However, the economic performance was affected by the ethnic conflict in 1983.

Table 5.1

Economic Performance

	1971-73	1974-75	1976-81	1982-87	1988-93	Projections 1994-98
Real GDP Growth (%)						
Sri Lanka	4.4	2.6	5.5	5.2	4.9	n.a.
All Developing Countries	5.1	6.3	4.9	4.4	4.9	5.9
Asia	6.5	5.6	5.9	7.3	7.1	6.9
Western Hemisphere	3.7	6.8	4.9	1.8	2.0	4.2
Domestic Savings (In % of GDP)						
Sri Lanka	14.4	8.2	14.0	13.7	13.7	n.a.
All Developing Countries	24.3	23.9	25.4	22.6	24.9	24.5
Asia	27.3	25.3	27.0	27.0	30.0	29.5
Western Hemisphere	18.5	18.1	19.7	16.4	19.6	19.3
Domestic Investment (In % of GDP)						
Sri Lanka	16.0	15.7	23.0	26.1	23.3	n.a.
All Developing Countries	24.8	25.8	25.5	24.0	24.7	n.a.
Indonesia, Korea, Malaysia	17.8	22.0	29.1	30.5	35.9	n.a.

During the period 1986-89 the GDP growth declined to 2 per cent mainly on account of a setback in agriculture and trading activities. Since 1989, the economy recovered with an annual growth rate of 5.5 per cent during 1990-93. A substantial increase in exports was observed during this period.

5.2 Domestic Savings

The total supply of savings is the sum of domestic savings and foreign savings. Domestic savings consist of the savings generated by the private and public sectors. Private savings arise from two sources namely, (a) corporate savings defined as the retained earnings of enterprises (corporate income after taxes minus dividends paid to shareholders), and (b) household savings which is equivalent to household earnings minus their consumption. Public or government savings are equivalent to the excess of government revenue over government consumption or recurrent expenditure.

A general characteristic of developing countries is the higher level of consumption in relation to GDP. As a result, domestic savings remain low in these economies. In Sri Lanka, about 87 per cent of the GDP was spent for consumption over the period 1971-93 (Table 5.2). This means that only 13 per cent of the GDP was saved. Domestic investment during the period was around 25 per cent and thus, domestic savings were inadequate to meet the high investment needs.

Table 5.2

	Domestic Consumption as % of GDP	Domestic Savings as % of GDP
1971 - 73	86.6	13.4
1971 - 76	87.8	12.2
1977 - 80	85.4	14.6
1981 - 85	86.2	13.8
1986 - 90	87.3	12.7
1991 - 93	85.3	14.7

As the economy grows, increased proportions of GDP need to be diverted to savings, so that the gap between domestic savings and investment (domestic revenue gap) narrows down. It implies the necessity to bring down the increase in consumption in relation to GDP growth. This trend can be measured in terms of the Marginal Propensity to Consume (MPC), which can be defined as the ratio of changes in consumption to change in GDP (Table 5.3). The concept of Marginal Propensity to Save (MPS), which is equal to 1 minus MPC, indicates relations between changes in savings and GDP growth. It can be seen that an unit increase in GDP brought about 0.86 increase in consumption in the long run (1971-93). In other words savings

increased only by 0.14 units in response to an unit expansion in GDP. This is not adequate to sustain long term growth. However, the gradual decline of MPC (and the corresponding increase in the MPS) from 0.89 in 1971-76 to 0.81 in 1991-93 is a favourable development.

Table 5.3

	Marginal Propensity to Consume	Marginal Propensity to Save
1971 - 73	0.86	0.14
1971 - 76	0.89	0.11
1977 - 80	0.88	0.12
1981 - 85	0.85	0.15
1986 - 90	0.85	0.15
1991 - 93	0.81	0.19

5.3 Policy Measures to Raise Domestic Savings

Adequate level of investment is imperative to achieve economic growth. However, economic growth achieved through strenuous efforts is not sustainable in the long run unless economic stability is ensured. Therefore, there should be a policy strategy to help attain economic stability in the country mainly through monetary policy instruments. Domestically, the general price level needs to be stabilised. Externally, the balance of payments should reach equilibrium. Inflation has adverse effects on the export sector and the resulting external payments imbalance tends to disturb the growth momentum. The responsibility of the monetary authorities in this context is to help in setting up an economic environment for a steady growth path without disrupting stability either internally or externally. The monetary authorities have attempted to perform this task over the past four decades by adopting various policy measures including the use of monetary instruments, control of the banking system and non-bank financial institutions, exchange rate management and exchange control.

The monetary and financial management adopted by the Central Bank, from time to time, has been geared to facilitate the achievement of broad economic objectives of different regimes. In this connection, it is significant to note that the Central Bank diversified its functions to meet the challenging demands of a growing

economy, particularly to promote domestic savings. A package of fundamental policy reforms was introduced in 1977. These policies were aimed at more efficient resource allocation through trade liberalisation, a flexible pricing and exchange rate system, a rationalised tariff structure and prudent monetary and financial policy measures. These policies were expected to promote economic growth and employment prospects.

The motivation of the private sector to invest depends on the prevailing investment climate to a considerable extent. Therefore, private investors should have confidence in the economic policies that are to be followed.

For this purpose, a package of monetary and fiscal policies was introduced since 1977. These included interest rate reforms, extending credit facilities to the private sector, development of the share market, encouragement to open foreign bank branches and incentives to foreign investors. The Central Bank also took action, from time to time through its monetary controls, to help maintain stability in the general price level and the balance of payments. The assurance of stability in these two spheres is a prerequisite to attracting domestic and foreign investment.

Since 1981, the Central Bank formulated the National Credit Plan annually as a guide to credit operations of commercial banks and long-term credit institutions. These plans indicated the targetted credit allocations to each sector in terms of national priority. This was very effective in diverting investible resources to more productive purposes in terms of national priorities.

5.4 Development of the Capital Market

The share market in Sri Lanka began in the early 19th century and was active in meeting the capital requirements of the plantation sector during the colonial regime. The market became weak with the introduction of exchange control regulations in the 1950's and subsequent policies geared towards nationalisation of private enterprises.

Following the liberalised economic policies adopted since 1977, the private sector was expected to play a more important role in revitalising the economy. Therefore, the Government introduced a series of policy reforms to encourage private sector participation. A number of fiscal incentives and tax concessions were granted to shareholders and companies issuing shares to the public. The outdated Companies Ordinance of 1938 was amended in 1982. The new Act has helped to build up much needed confidence among the public so as to popularise share market

activities.

The establishment of the Colombo Stock Exchange in September 1982 was a further step in the expansion of the share market. The Central Bank initiated setting up a Capital Issues Committee to facilitate share market transactions in 1982. Action was also taken to encourage the establishment of specialised intermediaries, such as share brokers, merchant banks, development banks and management consultancy firms. In order to regulate the activities of the market, the Securities Council Bill was passed in Parliament in 1987. These measures contributed to the increased activities of the share market as shown in Table 5.4.

Table 5.5

Foreign Private Investment (SDR Mn.)

Year	Direct Investment	Portfolio Investment	Total
1980	33	-	33
1981	42	-	42
1982	57	-	57
1983	35	-	35
1984	32	-	32
1985	24	-	24
1986	24	-	24
1987	45	-	45
1988	32	-	32
1989	14	-	14
1990	24	7	31
1991	46	24	70
1992	86	18	104
1993	134	48	182

Source : Central Bank of Sri Lanka.

5.5 Foreign Investment

As explained above, the domestic savings are inadequate to meet the capital requirements of the economy. Therefore, the domestic savings-investment gap needs to be filled by foreign investment. For this purpose, the government actively promoted Foreign Direct Investment (FDI). Since the late 1970's, in pursuance of this policy, the Greater Colombo Economic Commission (GCEC) was established by an Act of Parliament on January 31, 1978, with the principal objective of encouraging and regulating foreign investment inflows in export-oriented activities, principally within demarcated Export Processing Zones (EPZs) in Sri Lanka.

Earlier, the FDI in Sri Lanka came under the purview of two regulatory authorities - the GCEC and the Foreign Investment Advisory Committee (FIAC), a non-statutory agency established in the late sixties under the Ministry of Finance. The three key distinctions between GCEC and FIAC projects were:

- (a) GCEC projects were entirely foreign-owned or joint ventures in which the entire working capital and entire foreign costs of fixed assets were foreign financed, while FIAC projects were joint ventures with a local majority holding;
- (b) GCEC projects were at least 90 per cent export-oriented while FIAC projects were not; and
- (c) While the GCEC was able to provide infrastructural support services to projects within its Export Processing Zones, such facilities were not available to FIAC projects.

With a view to unify and simplify procedures for investors, the FIAC was brought under the authority of the GCEC in 1990. The GCEC was renamed as the Board of Investment (BOI) with effect from 1991. However, specialised activities such as banking, financial institutions, trading services in the Colombo Stock Exchange, insurance, air transportation, coastal shipping, production and distribution of energy and power; large scale mechanised mining of gems, branches of liaison offices of companies incorporated outside Sri Lanka, and lotteries, regulated by special legal enactments, remain outside the purview of the BOI.

Investors are free to invest in any sector of the economy. However, foreign investment is not permitted in a very few activities, namely, money lending, pawnbroking, retail trade with an investment of less than US dollars 1 million,

personal services other than for exports or tourism and coastal fishing. Moreover, a few specialised and security related activities, such as manufacturing of arms and ammunition, poisons and hazardous materials, currency, coins and security documents, require a special licence from the relevant authorities. There is no restriction on the size of investment or source of funds. Investments can be made for the manufacture of products for export or for the domestic market.

Foreign investment in local firms where the current foreign equity component is less than 40 per cent is automatically approved, with the exception of the few items given above, which remain excluded. Foreign investment in new firms in excess of 40 per cent is automatically approved except in the case of a short list of activities.

Investments with a foreign equity component are subject to the approval of the BOI. There is no requirement to obtain industrial licences to set up new companies. Investors are only required to furnish basic information on proposed business activities to the Registrar of Companies for statistical purposes.

The infrastructure of the country has been developed considerably in recent years to facilitate greater economic activity. The Ceylon Electricity Board, responsible for the generation and distribution of electricity, has an installed capacity of over 1,000 MW. Electricity generation is mainly through hydro-power but supplemented with thermal power at times.

The Island is accessible through an extensive network of roads (69,000 Km) and railway tracks (1,944 Km). Most of the trunk roads have been rehabilitated with the assistance from the World Bank and ADB.

The Colombo International Airport at Katunayake has been improved with expanded facilities for passengers and cargo. These include prompt passenger services and opening of a range of duty free and gold shops.

The port of Colombo is a modern and efficient port in South Asia. The Government liberalised shipping in 1990 and as a result, the number of lines calling in Colombo increased substantially. The Port will be developed further under a major development programme which will enable it to handle upto 1.4 million containers by the year 2000. A third container berth was opened by 1992. Action has also been taken to develop the the Port of Galle located in the South. This Port will facilitate the Export Processing Zone of the GCEC in Koggala.

The telecommunication service which had been handled by a government department is now under a Corporation. The telecommunication system has been modernised recently with Japanese assistance. Considerable improvements have been made in international subscriber dialing, telex, facsimile, and data transmission services. These are supplemented by cellular telephone systems and other micro wave communication facilities.

In order to protect health and environment in the Export Processing Zones, infrastructure facilities have been developed to supply potable water conforming to WHO standards and to dispose waste water and solid wastes. All BOI enterprises are required to adhere to the National Environment Act for setting up of projects and operations both within and outside Export Processing Zones. Accordingly, the BOI has adopted technical specifications on environmental standards for the following items :

- (a) Drinking Water Standards
- (b) New Source Air Emission Norms
- (c) Noise Level Criteria
- (d) Environmental Licensing Procedure
- (e) Tolerance Limits for Industrial Waste Water (Effluents) discharged into the Common Waste Water Treatment Plant
- (f) Tolerance Limits for Industrial Waste Water (Effluents) discharge into Inland Surface Water (after treatment)
- (g) Tolerance Limits for Industrial Waste Water (Effluents) discharged into Marine Coastal Waters
- (h) Tolerance Limits for Industrial Effluents discharged on Land for Irrigation purposes
- (i) Hydraulic Loading Applicable for Different Soils
- (j) Classification of Industries and Recommended Buffer Zones.

A series of incentives have been granted to attract foreign investment. In order to mobilise equity funds for investment, several incentives have been granted for setting up of Venture Capital Companies and Unit Trusts/Mutual Funds. In the case of Venture Capital Companies, profits and income are exempted from tax for a period

of 10 years after commencement. Profits and income of Unit Trusts/Mutual Funds are exempted from income tax for a period of 5 years from commencement. Capital gains derived from the sale of stocks and shares by Venture Capital companies and Unit Trusts/Mutual Funds are also exempted from tax.

A five year tax holiday is available for pioneering undertakings, companies providing infrastructure facilities and expansion of industrial undertakings.

New companies engaged in certain specified activities of agriculture and animal husbandry are exempted from income tax a period of 5 years.

The profits and income of new companies engaged in marine or inland fisheries are granted a tax holiday of 5 years.

Profits and income from exports, realised by a new company incorporated for the manufacture and export of any commodity, approved by the Ministry of Finance are exempted from tax for a period of 5 years. This concession is also extended to the Export Production Village Companies and to persons who supply goods to exporters and BOI enterprises.

Activities of certain specified on-shore and off-shore companies are exempted from tax for a five year period.

Dividends declared out of exempt profits by a company during its tax holiday period or one year thereafter are exempted from tax.

Liberalisation of exchange and trade controls has helped to attract foreign investment. In addition, several specific schemes have been introduced to further facilitate foreign investment.

A Resident Guest Scheme was set up in February 1991 in order to grant attractive benefits to foreign investors and professionals. A potential investor remitting a sum of US \$ 150,000 or its equivalent in convertible currency will be issued a travel document enabling him/her to travel freely to and from Sri Lanka. His/her dependents will be given the travel facility on a further remittance of US \$ 25,000 per person. The investor could also take up residence for an initial period of 5 years which may be extended. The funds are to be deposited in a commercial bank in a special account approved by the Central Bank. Interest will be paid on all unutilised deposits. Investments out of the deposits referred to above, or any further sums remitted by the applicant, could be made in any project approved by the BOI or any other relevant authority. A series of incentives are available for such projects.

With a view to attracting foreign exchange, the scheme of Resident Foreign Currency Accounts (RFCA) was introduced in August 1991. Interest accruing to any person lying to his/her credit in a RFCA is exempted from income tax in terms of Section 10(e) of the Inland Revenue Act. Inland Revenue Act was to be amended so as to exclude, with effect from the year of assessment 1991/92, the funds lying to the credit of any person in a RFCA from his/her wealth. The following categories of persons are allowed to open RFCAs with commercial banks in designated currencies.

Category A: Individuals (other than Category C below) whether citizens or non-citizens resident in Sri Lanka who are in a position to deposit foreign currency to a minimum of US \$ 500 or its equivalent in other designated currencies out of inward remittances and/or currencies brought into the country on a declaration to Customs, without the prior approval of the Controller of Exchange.

Category B : Other Sri Lankan residents who hold designated foreign currencies to the value of over US \$ 500 per person in Sri Lanka.

Category C : Exporters of goods and services who have increased their export earnings in foreign exchange terms over the previous year ending 31st December, upto a 5 per cent of the annual increase, taking into account the year ending 31st December 1990 as the base year, without the prior approval of the Controller of Exchange, with effect from 1st January 1992.

In order to facilitate foreign investment in shares of companies, the Scheme of Share Investment External Rupee Accounts (SIERA) was introduced with effect from 29th June 1992. Country Funds, Regional Funds, foreign citizens and Sri Lankan resident outside Sri Lanka are allowed to operate these accounts. Inward remittances and other specified foreign exchange can be credited to these accounts and such funds can be used for share market transactions.

The policy measures induced foreign capital inflows (Table 5.5). Direct investments were mainly for the industries under the BOI. These investments rose from SDR 33 million in 1980 to SDR 134 million in 1993. Following the capital market development since the late 1980's, portfolio investment (share market investments) rose from SDR 7 million in 1990 to SDR 48 million in 1993.

With a view to increasing further exchange the scheme of Resident Foreign Currency Accounts (RFCAs) was introduced in August 1971. It was a step towards... Section 115C of the Income Tax Act, 1961, which was inserted in the Finance Act, 1971, with effect from the year of assessment 1971-72, the funds... the credit of any person in a RFCA, in whichever year. The following categories of persons are allowed to open RFCAs with commercial banks or designated companies:

Category A: Individuals other than citizens of India who are in a position to deposit foreign currency to a minimum of Rs. 5,000 or its equivalent in other designated currencies or to a minimum of Rs. 5,000 or its equivalent in other... into the country on a declaration in Form... without the prior approval of the Controller of Exchange.

Category B: Over 21 Indian residents who hold designated foreign... accounts to the value of over Rs. 5 lakhs or person in 21 lakhs.

Category C: Exports of goods and services who have increased their export earnings in Indian exchange terms by 10% or more in the previous year ending 31st December upto a total of 10% or more in the annual increase taking into account the year ending 31st December 1969 as the base year without the prior approval of the Controller of Exchange, with effect from 1st January 1972.

In order to further encourage investment in shares in companies, the scheme of State Investment External Reserve Accounts (SIERAs) was introduced with effect from 29th June 1972. Company Bonds, National Bonds, Foreign Currency and 21 Indian resident outside 21 lakhs are allowed to open these accounts. Foreign currencies and other specified foreign exchange can be credited to these accounts and such funds can be used for capital market investments.

The policy measures introduced to increase export receipts (Table 2.2) Direct investments were mainly for the industries under the EOI. These investments rose from Rs. 13 million in 1970 to Rs. 135 million in 1977. Following the rapid... under development since the late 1970s, portfolio investment (both market... in companies rose from Rs. 2 million in 1970 to Rs. 48 million in 1977.

CHAPTER 6

PRODUCTION STRUCTURE AND SECTORAL GROWTH

6.1 Changes in Production Structure

The production structure of the economy has changed over the years in response to the policy reforms and other exogenous and endogenous factors. For the purpose of analysing these structural changes let us categorise the GDP into following 4 sectors:

1. *Agriculture, Forestry and Fishing* : Agriculture includes tea, rubber, coconuts, paddy, subsidiary food crops and minor crops. Forestry, fishing and mining and quarrying sub-sectors are also classified in this category in view of the primary nature of their production.
2. *Manufacturing and Construction* : The manufacturing sub-sector includes export processing, factory industry, small industry and other industries. In addition, we may include construction under this category.
3. *Economic and Social Infrastructure*: This sector consists of (a) Electricity, gas and power, (b) Transport, storage and communication (c) Construction and (d) other infrastructure services (education, etc.).
4. *Economic Services*: This sector includes (a) Foreign trade (exports and imports), (b) Domestic trade and (c) Banking, insurance and real estates.

A salient development in the production structure during the period between 1970 and 1993 is the decline in the share of agriculture and allied activities from 32 per cent to 23 per cent (Table 6.1). This sector grew only by 2.8 per cent per annum in 1971 - 93. The rate of growth of agriculture in 1986 - 93 was below the long term growth and was only 1.5 per cent. This was mainly due to the stagnation of the plantation sector. In contrast, the category of economic services has captured a prominent position from 20 per cent in 1970 to 27 per cent in 1993. Economic services rose by about 5 per cent per annum during 1977 - 93. The rise in economic services can be mainly attributable to the growth of foreign and domestic trade following the liberalisation. Financial services also expanded during this period.

Table 6.1

Structure of GDP

	Annual Average Growth %				Composition of GDP			
	1971 - 93	1971 - 76	1977 - 85	1986 - 93	1970	1977	1985	1993
1. Agriculture & Allied Activities	2.8	1.1	3.1	1.5	32	32	28	23
2. Industry	5.1	1.4	3.1	7.5	17	16	15	19
3. Economic & Social Infrastructure	4.4	2.1	3.9	3.7	31	31	32	31
4. Economic Services	5.7	1.9	5.4	4.8	20	21	25	27
GDP	4.4	1.6	3.9	4.0	100	100	100	100

Source: Compiled from Central Bank Annual Reports

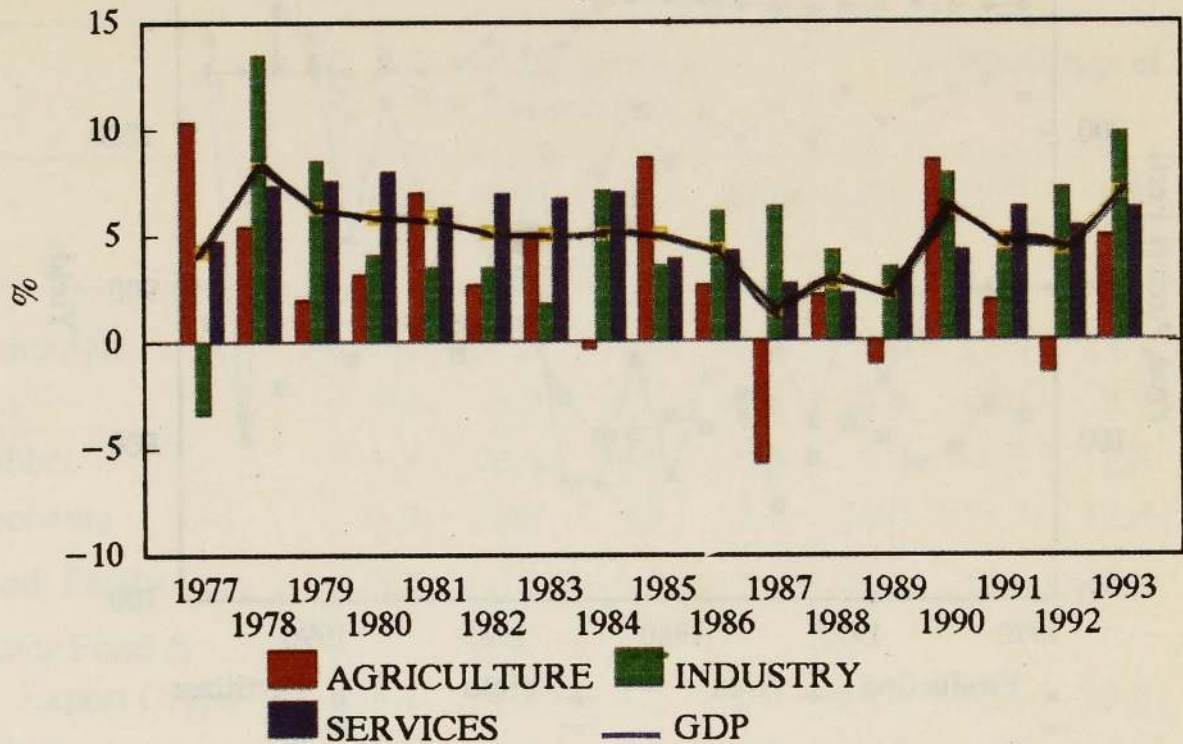
The industrial sector increased by around 5.1 per cent per annum during 1970 - 93. However, its share increased only marginally from 17 per cent to 19 per cent during this period. Factory industry grew considerably since the early 1980s. But this was not fully reflected in the overall industrial production due to the slackening of processing industries of plantation crops. Economic infrastructure sector held nearly one third of GDP throughout the period 1970 - 93 reflecting an annual growth rate of about 4.4 per cent. As a result of a considerable increase in public investment for infrastructure development, this sector grew rapidly since the late 1970's.

6.2 Agriculture and Allied Activities

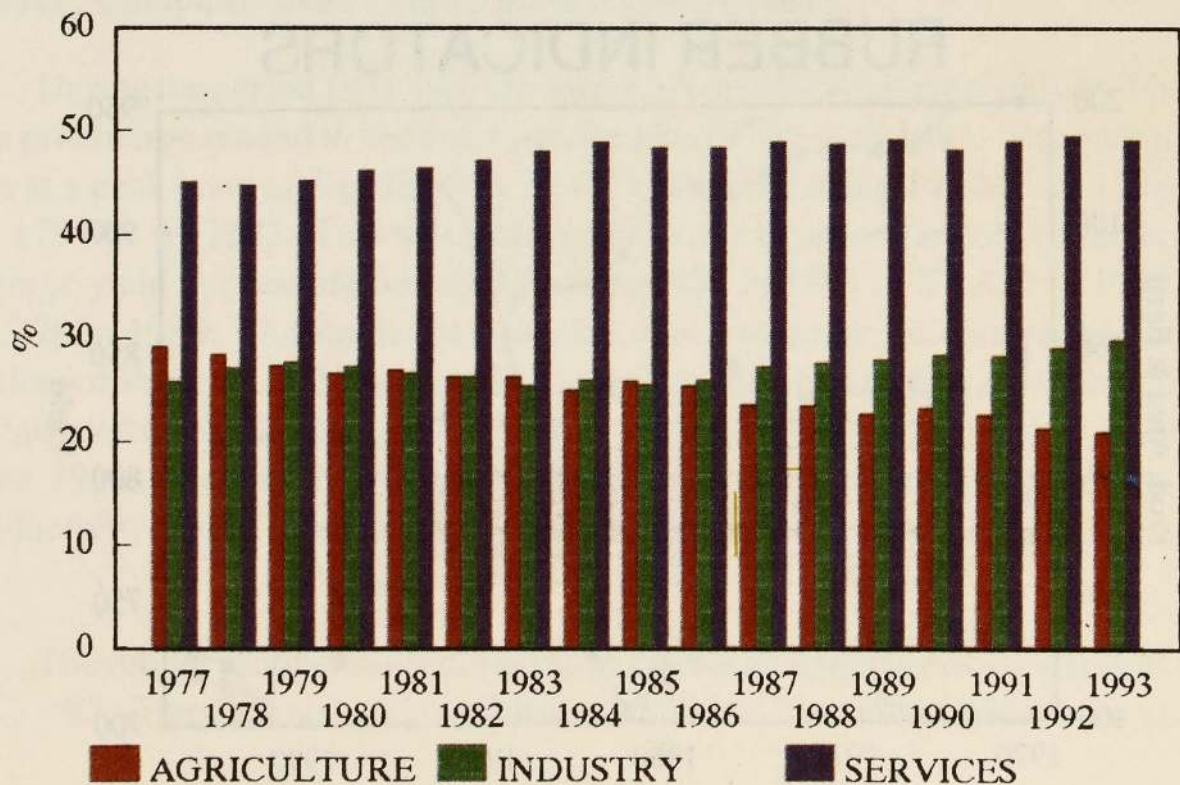
The plantation sector, which accounted for more than one third of total agricultural production in 1970, now represents less than one fifth of the production (Table 6.2). The share of all plantation crops, namely tea, rubber and coconuts fell during the period 1970 - 93. The output of the plantation sector rose only by 0.2 per cent in 1971 - 93. The output recorded a decline in the period 1971 - 76 and 1986-93.

ANNUAL GROWTH BY SECTOR

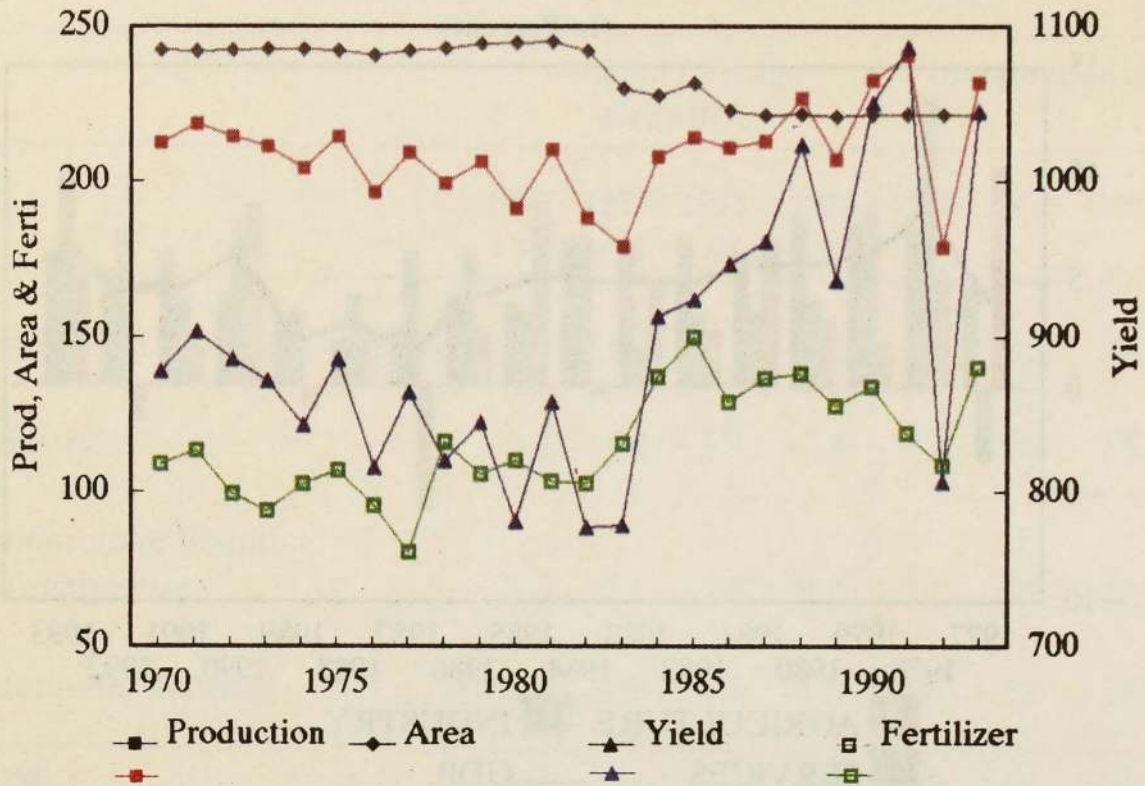
(In Percent)



COMPOSITION OF GDP



TEA INDICATORS



RUBBER INDICATORS

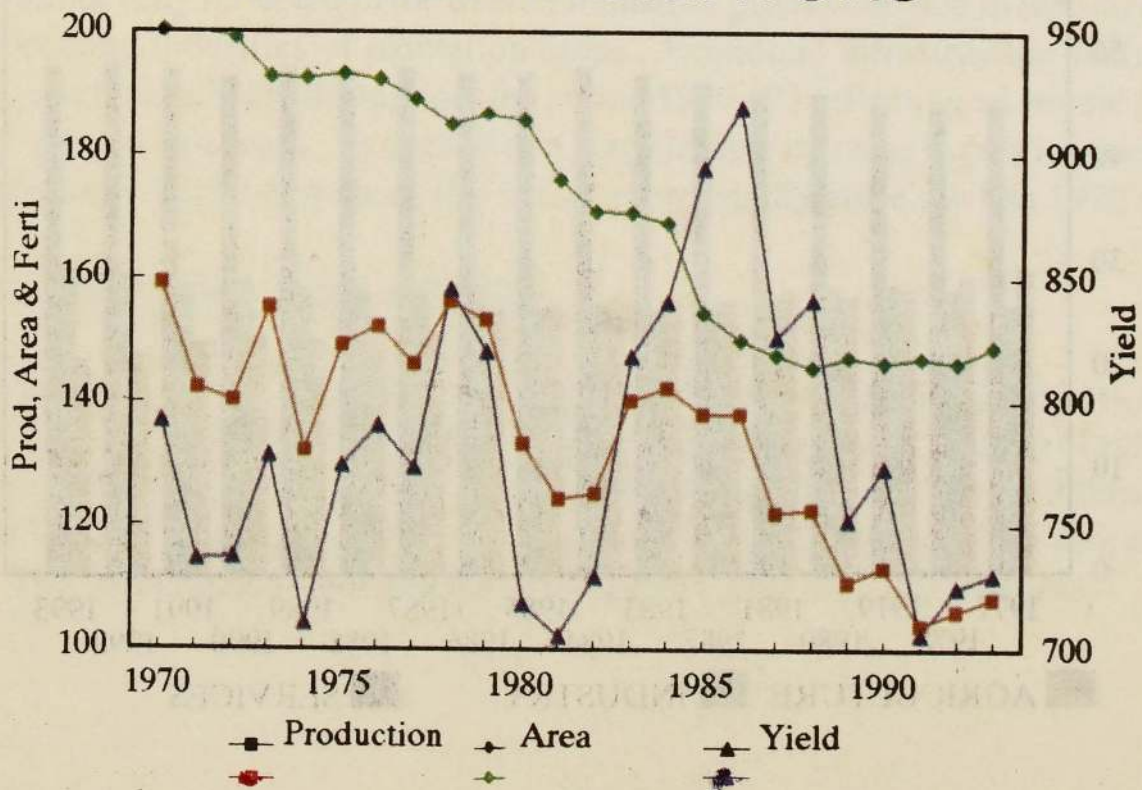


Table 6.2

Output of Agriculture and Allied Activities

	Annual Average Growth (%)				As Percentage of Total			
	1971 - 93	1971 - 76	1977 - 85	1986 - 93	1970	1977	1985	1993
Plantation	0.2	-1.2	1.7	-1.4	35.6	27.8	24.1	18.7
Tea	1.0	-1.2	0.8	2.1	14.4	12.5	8.9	8.6
Rubber	-1.3	0.5	-0.8	-2.6	5.2	4.2	2.8	2.0
Coconuts	1.3	-0.6	3.9	-2.7	16.0	11.2	12.4	8.1
Food: Paddy	3.3	-2.8	6.2	0.3	21.6	19.8	22.0	18.6
Minor Food & Export Crops	5.1	6.4	3.2	3.7	24.7	33.6	33.3	39.6
Fishing	1.6	-2.5	2.7	1.6	8.3	5.8	6.2	6.2
Mining & Quarrying	36.4	119.6	2.8	5.5	1.5	7.2	8.1	10.7
Forestry	1.6	-2.5	2.7	1.6	8.3	5.8	6.2	6.2
Total	2.8	1.1	3.1	1.5	100.0	100.0	100.0	100.0

Source: Computed from Central Bank Annual Reports.

During the period 1971 - 93, the output of tea sub-sector grew only by 1 per cent. Tea production tended to decline since the late 1970's upto 1983. The output which was at a peak level of Kg. 281 Mn. in 1971 declined to Kg.199 Mn. in 1978 and to Kg.179 Mn. by 1983. This was mainly due to the deterioration of productivity; the average yield per hectare declined from Kg.902 in 1971 to Kg.819 in 1978 and to Kg.778 in 1983. During the past decade, the area under tea cultivation showed a decline of about 21,000 hectares. But tea production had an upward trend recording a peak level of Kg.232 Mn. by 1993. This was an outcome of the production increase since 1984. Increased fertilizer application seems to have contributed to higher productivity levels. The average yield per hectare was around Kg.1,000 in 1990 - 93.

The rubber production declined at an annual average rate of 1.3 per cent during 1971 - 93. The decline was prominent after 1980. The output which was at a peak

ownership. These industries were geared to import substituting purposes and heavy protection was given. As a result, the private sector participation in industrial development had narrowed down until the economic reforms of 1977. Since then policy measures have been implemented to limit state ownership and to induce the private sector in export-oriented industries.

Table 6.3

Output of Industrial Sector

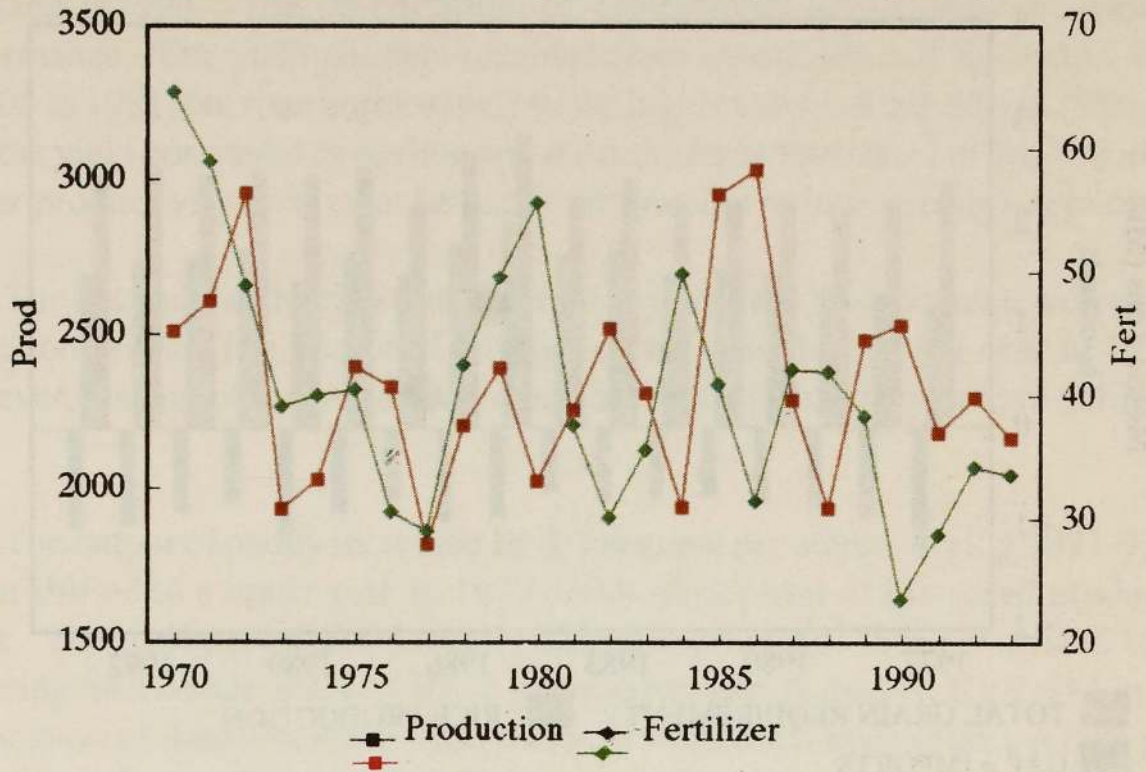
	Annual Average Growth (%)				As Percentage of Total			
	1971 - 93	1971 - 76	1977 - 85	1986 - 93	1970	1977	1985	1993
Export Processing	0.2	-0.4	0.6	0.0	32.2	29.5	32.1	29.5
Factory	6.8	2.1	4.0	10.2	57.6	61.1	59.7	61.1
Small Scale	7.2	12.0	3.7	4.4	3.2	2.9	2.2	2.9
Other	2.1	0.6	4.6	-2.7	7.0	6.5	6.0	6.5
Total	5.1	1.4	3.1	7.5	100.0	100.0	100.0	100.0

Source: Computed from Central Bank Annual Reports.

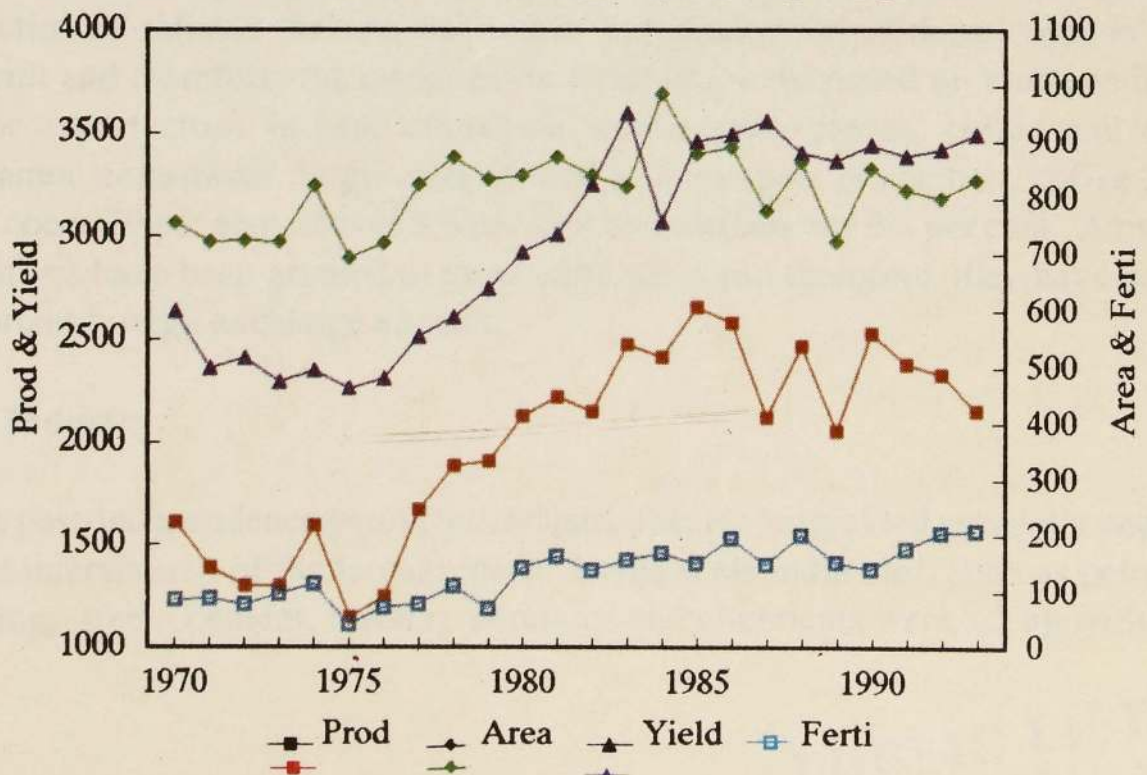
Factory industry accounted for nearly two thirds of total industrial production (Table 6.3). During 1971-93, the industrial output grew by 6.8 per cent per annum. Following the liberalisation of the economy, the private sector and foreign investors started to engage in industrial activities at a large scale and consequently the factory industry output grew by 4 per cent in 1977-85 and accelerated at 10.2 per cent during the subsequent period. This was entirely due the contributions made by the private sector. During the period 1978-91, the output of private sector grew by 16 per cent while that of the public sector declined by 1 per cent. It is significant to note that the share of public sector in total industrial production fell from 64 per cent in 1980 to 25 per cent in 1990. This was due to a decline in output levels of public sector industries and privatisation of a large number of state-owned enterprises after 1988.

The output of export processing relating to plantation sector products increased only by 0.2 per cent per annum during 1990-93. The stagnation of this sub-sector reflects the decline in processing activities associated with the plantation sector. These industries were started during the colonial regime to prune traditional exports.

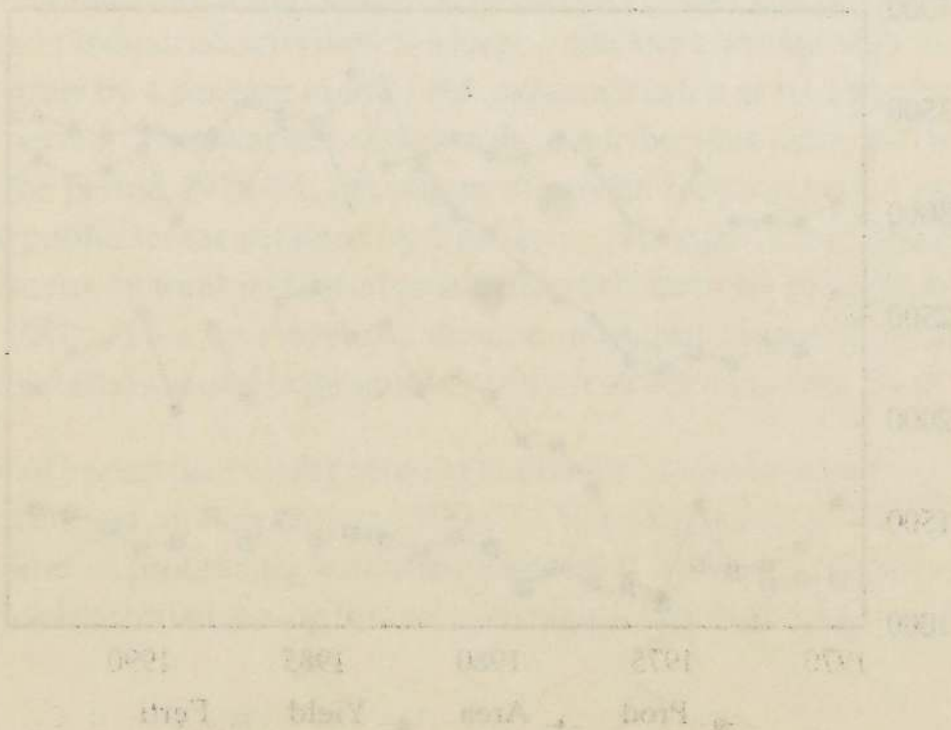
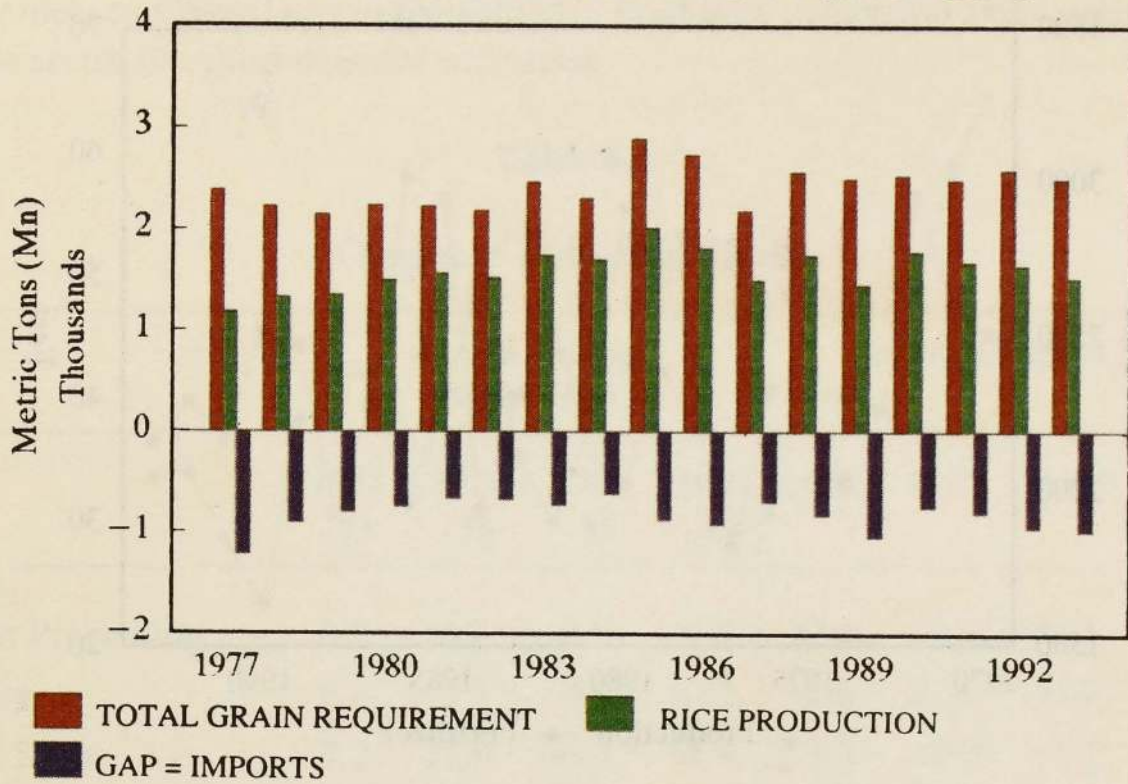
COCONUTS: INDICATORS



PADDY: INDICATORS



GRAIN PRODUCTION GAP



level of Kg.159 Mn. in 1970 fell down to Kg.133 Mn. in 1980 and to Kg. 180 Mn. 1993. This can be partly explained by the contraction of area under rubber from hectares 230 thousand in 1970 to hectares 205 thousand in 1980 and to hectares thousand in 1993. The deterioration of productivity also tended to worsen the performance. The yield per acre declined from a peak level of Kg.845 in 1978 to Kg.705 in 1981, but rose impressively to the highest level of Kg.919 in 1986. Since then the yield continued to decline and it reached a bottom level of Kg.730 in 1993. Lower productivity levels can be partly attributable to low fertilizer application.

The coconut production fluctuates more frequently as compared with the other plantation crops. The output of this sub-sector grew by 1.3 per cent in 1971-93. However, the output showed a decline at a rate of 2.7 per cent per annum during 1986 - 93.

The output of paddy increased by 3.3 per cent per annum during 1971-93. The output shifted to a upper path in 1979 partly on account of increased productivity levels. The paddy production rose to a peak level of MT 2,661 thousand in 1985 reflecting an average yield of Kg. 3,465 per hectare as against Kg.2,644 in 1970. Application of intensive cultivation methods helped achieve higher average yields. Expansion of area under paddy cultivation, particularly in the Mahaweli areas also contributed to the increase in paddy output.

The output of subsidiary food crops and minor export crops grew by 5.1 per cent per annum in 1971-93. As a result of this impressive growth, this sub-sector now accounts for two fifths of the overall agriculture. The main subsidiary crops are cereals, pulses, root crops, oil seeds, spices and fruits. These crops are mainly cultivated in home gardens and in small scattered plots under rainfed conditions. The collection of reliable data on the extent and production of these crops is rather difficult and therefore, the statistics on these crops are based on crude estimates. Minor export crops include cinnamon, cardamoms, cloves, coffee and cocoa. Cinnamon contributes 32 per cent of total minor export production, coffee 32 per cent, cocoa 19 per cent, cloves 5.6 per cent and cardamoms 3.1 per cent. A range of incentives have been granted to these cultivators and therefore, they have become important foreign exchange earners.

6.3 Industry

In the post-independence period the industrial sector progressed gradually under the direct intervention of the Government. Large scale industries, such as petroleum refining, steel, cement, leather, ceramics and chemicals were set up with state

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6.4 Economic and Social Infrastructure

This sector covers public utilities (power, telecommunication, water supply, sanitation and sewerage), public works (roads and irrigation schemes), transport services, human resource development (health and education) and tourism. Sri Lanka has maintained a long standing reputation for her achievements in human development in terms of health and education indicators. These services grew by 5.2 per cent over the period 1971-93. The increase in output in this sub-sector was relatively higher before 1977 on account of the higher priorities given in that period.

Table 6.4

Economic and Social Infrastructure

	Annual Average Growth (%)				As Percentage of Total			
	1971 - 93	1971 - 76	1977 - 85	1986 - 93	1970	1977	1985	1993
Electricity, Gas & Power	7.7	3.3	7.1	6.3	2.4	2.4	2.3	2.4
Transport, Storage & Communication	4.6	2.2	4.2	3.7	35.5	36.6	37.1	36.6
Construction	3.0	-1.1	3.4	3.3	32.1	27.6	27.8	27.6
Health, Education, Tourism and Other Services	5.2	5.2	3.8	3.6	30.0	33.4	32.8	33.4
Total	4.4	2.1	3.9	3.7	100.0	100.0	100.0	100.0

Source : Computed from Central Bank Annual Reports.

Output in transport, storage and communication grew by 4.6 per cent in 1971-93. The growth accelerated following the economic reforms due to increased availability of the facilities.

The output in the construction sector grew by 3 per cent during 1971-93 and the sub-sector accounts for about one fourth of the total output. Electricity, gas and power contributed about 2.4 per cent of the output and reflected a growth rate of 7.7 per cent in 1971-93.

6.5 Economic Services

Trading activities account for about 90 per cent of the total output in this sector. Foreign trade, which represents nearly one half of the output, grew by 5.3 per cent in 1971-93. This is mainly attributable to the increase in both exports and imports after the liberalisation. Nevertheless, the share of foreign trade in the output of the sector declined from 54 per cent in 1970 to 45 per cent in 1993 owing to a faster increase in domestic trade. Domestic trade contributed about two fifths of the output in the sector. The output of domestic trade rose by 5.8 per cent. Unlike foreign trade, the rate of growth of domestic trade is lower in the post-liberalisation regime. However, the share of domestic trade increased from 37 per cent to 44 per cent between 1970 and 1993.

Table 6.5
Economic Services

	Annual Average Growth (%)				As Percentage of Total			
	1971 - 93	1971 - 76	1977 - 85	1986 - 93	1970	1977	1985	1993
Foreign Trade	5.3	-2.3	6.2	5.4	54.1	45.3	48.7	45.3
<i>Imports</i>	6.1	-2.8	8.0	4.8	38.3	30.0	33.6	30.0
<i>Exports</i>	3.9	-0.3	1.8	7.8	15.8	15.3	15.1	15.3
Domestic Trade	5.8	7.2	4.0	3.6	36.9	43.8	40.9	43.8
Banking, Insurance & Real Estate	9.8	9.3	7.9	6.2	9.0	10.9	10.5	10.9
Total	5.7	1.9	5.4	4.8	100.0	100.0	100.0	100.0

Source: Computed from Central Bank Annual Reports.

The output of financial services, namely banking, insurance and real estate transaction, increased by 9.8 per cent in 1971-93. The share of the sector expanded marginally from 9 per cent in 1970 to 11 per cent in 1993.

The top activities in terms of value added in the sector are foreign trade, transport and communication, and banking. The share of foreign trade in the output of the sector declined from 24 per cent in 1970 to 11 per cent in 1993 owing to a fall in the output of the sector. The output of banking and communication services grew by 7.7 per cent in 1971-93. This is mainly attributable to the increase in both exports and imports after liberalization. The share of banking in the output of the sector declined from 24 per cent in 1970 to 11 per cent in 1993 owing to a fall in the output of the sector. The output of banking and communication services grew by 7.7 per cent in 1971-93. However, the share of domestic trade declined from 37 per cent to 24 per cent between 1970 and 1993.

Table 4.2: Economic Services

As Percentage of Total	Annual Average Growth (%)		
	1970-1973	1973-1977	1977-1993
Foreign Trade	24.1	24.1	24.1
Banking	24.1	24.1	24.1
Transport & Communication	24.1	24.1	24.1
Domestic Trade	24.1	24.1	24.1
Other	24.1	24.1	24.1
Total	24.1	24.1	24.1

Source: Computed from Census of India (1970, 1977, 1993)

The output of the sector grew by 7.7 per cent in 1971-93. The share of the sector expanded marginally from 9 per cent in 1970 to 11 per cent in 1993.

CHAPTER 7

LABOUR MARKET DEVELOPMENTS

7.1 Demographic Changes

The population grew at a faster rate in the 1950's and 1960's (Table 7.1). Since then there has been a declining trend in the increase in population. The annual population growth declined from around 2.5 per cent in the 1960's to 1.2 per cent by 1993. The crude birth rate declined from 36.6 per 1000 in 1960 to 20.1 in 1992 largely as a result of family planning practices. The rate of mortality in 1992 was only 14.5 per 1000 as compared with 28.0 in 1960.

As in many other developing countries, Sri Lanka has a higher proportion of younger persons in contrast to developed countries where the proportions of older age groups are higher. However, a major change in the composition of population is the declining trend of the share of the younger age group. The share of 0-14 years declined from 41 per cent in 1960 to 35 per cent in 1993.

Table 7.1
Key Demographic Indicators

Item	Unit	1950	1955	1960	1965	1970	1978	1989	1990	1991	1992	1993
Mid-Year												
Population	'000	7,544	8,729	9,896	11,164	12,514	14,190	16,806	16,993	17,247	17,405	17,619
Male	'000	4,003	4,584	5,217	5,802	6,503	7,296	8,567	8,662	8,792	8,872	8,981
Female	'000	3,541	4,145	4,680	5,362	6,011	6,894	8,239	8,331	8,455	8,533	8,638
Population by Age Groups												
0 - 14	'000	2,808	3,550	4,024	4,674	5,244	5,531	5,917	5,982	6,070	6,126	6,203
15 - 54	'000	4,142	4,660	5,283	5,549	6,208	7,368	9,299	9,403	9,545	9,633	9,751
55 and over	'000	594	519	589	941	1,062	1,291	1,590	1,608	1,632	1,646	1,665
Population Growth Rate	%	0.9	2.5	2.5	2.4	2.1	1.8	1.3	1.1	1.5	1.0	1.2
Crude Birth Rate	per '000	39.6	37.3	36.6	33.1	29.4	28.5	21.3	20.1	21.0	20.1	n.a.
Crude Death Rate	per '000	12.6	11.0	8.6	8.2	7.5	6.6	6.2	5.7	5.6	5.6	n.a.
Rate of Natural Increase	per '000	27.0	26.3	28.0	24.9	21.9	21.9	15.1	14.4	15.4	14.5	n.a.
Net Migration Rate	per '000	-2.0	-2.0	-1.0	-	-8.0	-3.8	-1.2	1.2	-3.9	-4.1	n.a.
Density of Population	per sq. km.	116	135	153	172	194	219	260	263	268	270	273

Source: Department of Census and Statistics.

7.2 Labour Force

According to the estimates of the Census and Statistics Department, labour force is composed of the economically active population aged 10 years and over. Economically active population is defined as those persons who are/were employed or unemployed during the reference period of the particular survey. Employed persons are all household members who during the reference period worked as paid employees, employers, self-employed or unpaid family workers in family enterprises. The employed category also includes persons who had a job but were temporarily absent from work due to factors, such as vacation, illness, bad weather and labour management disputes. The unemployed are defined as persons who are available and/or looking for work and had no employment during the reference period.

The total labour force increased from 2.6 million in 1946 to 6.1 million in 1993 (Table 7.2). The rapid growth of population until the 1970's contributed to the expansion of labour force.

Table 7.3 shows the comparative growth data on population and labour force. Sri Lanka experienced a declining trend of population and labour force during 1970-92. The projection for the period upto year 2000 indicates a further decline in population growth. The labour force is projected to grow at the same rate prevailed during 1980-92.

Sri Lanka has attained considerable success in lowering population growth. The rate of growth of population of Sri Lanka has remained much below the group averages for low and middle income countries throughout the period 1970-92 and this trend is projected to continue upto year 2000. In line with this trend, the growth of labour force in Sri Lanka is lower than the low and middle income groups.

Table 7.2

Labour Force Estimates

YEAR	SOURCE	Labour Force Participation '000			Crude Participation Rate (%)		
		Total	Male	Female	Total	Male	Female
1946	Census of Population	2,611	2,041	570	39.2	57.8	18.2
1953	Census of Population	2,993	2,268	724	37.0	53.1	18.9
1963	Census of Population	3,464	2,742	722	32.7	49.8	14.2
1968	Labour Force Survey	4,150	3,156	984	34.6	50.7	17.2
1969/70	Socio-Economic Survey	4,169	3,124	1,045	38.6	57.3	19.5
1971	Census of Population	4,488	3,312	1,176	35.4	50.7	19.1
1973	Survey of Labour Force Participation Rates	4,560	3,267	1,293	34.4	48.5	20.2
1975	Land and Labour Utilisation Survey	4,957	3,490	1,467	36.5	50.2	22.1
1980/81	Socio-Economic Survey	5,715	4,109	1,606	37.3	53.1	21.2
1981	Census of Population	5,105	3,767	1,248	33.8	49.8	17.1
1981/82	Consumer Finances and Socio-Economic Survey	5,217	3,710	1,507	34.3	49.7	19.4
1986/87	-do-	6,239	4,104	2,135	38.1	51.7	25.4
1990	Labour Force Survey	5,916			50.7		
1991	-do-	5,894			49.3		
1992	-do-	5,948			48.9		
1993	-do-	6,066			49.5		

Table 7.3**Growth of Population and Labour Force**

(Average Annual Growth %)

ECONOMIES	Population			Labour Force		
	1970-80	1980-92	1991-2000(a)	1970-80	1980-92	1992-2000(a)
Low-income	2.2	2.0	1.7	2.2	2.2	1.7
Lower-middle-income	3.5	1.8	1.4	2.3	2.2	3.3
Upper-middle-income	2.5	1.8	1.5	2.9	2.3	2.1
Low and middle-income	2.5	1.9	1.6	2.3	2.2	1.9
Sub-Sahara Africa	2.8	3.0	2.8	2.4	2.5	2.7
East Asia and Pacific	1.9	1.6	1.2	2.4	2.1	1.8
South Asia	2.4	2.2	1.9	1.8	2.1	1.9
Europe and Central Asia	4.3	1.0	0.5	1.4	1.1	0.2
Middle East & North Africa	2.8	3.1	2.5	3.0	3.2	3.2
Latin America and Carribeans	2.4	2.0	1.6	3.1	2.5	2.3
High-income	0.8	0.7	0.5	1.3	0.6	0.4
World	2.2	1.7	1.5	2.1	1.9	1.7
Sri Lanka(b)	1.6	1.4	1.1	2.3	1.6	1.6

Source: World Bank, World Development Report.

(a) Projection

(b) In the World Bank Classification, Sri Lanka is grouped under the low-income group.

7.3 Employment

As shown in Table 7.4, the overall employment levels remained stagnant until the early seventies. Slow economic growth during that period led to low absorption of labour resulting in a high unemployment rate. Employment showed an increasing trend since the early eighties.

Table 7.4

Employment Estimates

(In Thousands)

YEAR	SOURCE	Estimated Employment		
		Total	Male	Female
1946	Census of population	2,612	2,042	570
1953	Census of Population	2,993	2,269	724
1963	Census of Population	3,200	2,543	657
1968	Labour Force Survey	3,674	2,835	839
1969/70	Socio-Economic Survey	3,610	2,775	835
1971	Census of Population	3,649	2,838	811
1973	Survey of Labour Force Participation Rates in Sri Lanka	3,767	2,820	947
1975	Land and Labour Utilisation Survey	3,973	2,990	983
1980/81	Socio-Economic Survey	4,851	3,623	1,228
1981	Census of Population	4,119	3,268	881
1981/82	Consumer Finances and Socio- Economic Survey	4,608	3,422	1,186
1986/87	-do-	5,272	3,640	1,632
1990	Labour Force Survey	4,951		
1991	-do-	5,083		
1992	-do-	5,159		
1993	-do-	5,227		

As evident from Table 7.5 labour absorption accelerated during 1981-90 providing employment annually to about 204 thousand new entrants to the labour market. Greater magnitudes of employment were provided in the sectors of Agriculture and Industry.

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The composition of employment in different sectors has changed over the years in line with structural changes in the economy. The Agriculture sector is still the highest employment generating sector, but its share in total employment fell from 53 per cent in 1953 to 48 per cent in 1990. The major contributing factor to this development was the increase in employment in the Manufacturing sector which showed an increase in its share from 10 per cent in 1953 to 15 per cent in 1990.

Table 7.5

Structure of Employment

Activity	Additional Labour Composition				% Increase				Composition					
	1953	1962	1971	1981	1953	1962	1971	1981	1953	1963	1971	1981	1990	
1. Agriculture, Forestry & Fishing	98	147	35	987	0.75	0.94	0.19	5.46	52.92	52.64	50.12	45.25	47.85	
2. Mining & Quarrying	-4	4	25	123	-4.69	3.76	11.41	19.57	0.46	0.29	0.36	0.94	2.71	
3. Manufacturing	3	47	77	449	0.13	1.67	2.08	9.57	9.66	9.15	9.30	10.12	14.53	
4. Construction	28	19	21	59	5.21	2.21	1.84	4.96	1.89	2.66	2.84	3.02	3.07	
5. Electricity, Water & Sanitary	5	2	6	-2	11.35	2.33	4.70	-1.56	0.11	0.24	0.26	0.37	0.22	0.33
6. Trade	66	-5	90	76	2.67	-0.17	2.34	2.05	9.45	10.93	9.42	10.52	8.55	
7. Transport	33	41	20	48	3.54	2.96	1.06	2.74	3.48	4.31	4.90	4.83	4.14	
8. Finance	-50	9	21	4	-16.35	5.33	6.21	1.06	2.17	0.49	0.68	1.10	0.83	
9. Other Services	22	190	176	96	0.46	3.04	1.99	1.17	19.84	19.29	22.11	23.85	18.09	
	202	454	470	1840	0.82	1.67	1.53	4.72	100.00	100.00	100.00	100.00	100.00	

Source : Department of Census and Statistics.

Under the market-oriented economic strategy adopted since 1977, there was an increasing trend in the employment in the private sector (Table 7.6).

Table 7.6

Employment in the Private Sector ('000)

1978	469
1980	518
1985	556
1990	724
1993	973

Data on occupational distribution of employed persons for recent periods are available from the Quarterly Labour Force Surveys (Table 7.7). In the second quarter of 1993, about 37 per cent were engaged in elementary occupations and 28 per cent in skilled, agricultural and fisheries activities. The other major occupations were craft and related workers and professionals.

Between 1990 and 1993, marginal increases were recorded in the categories of professionals, clerks and skilled agricultural workers. The proportion of craft and related workers increased significantly between the two quarters.

Table 7.7
Employment by Occupation (%)

Occupation Group	1st Qtr. 1990	4th Qtr. 1993*
1. Senior Officers and Managers	0.93	1.5
2. Professionals	4.55	7.9
3. Technicians & Associate Professionals	3.22	3.6
4. Clerks	2.62	4.3
5. Sales & Service Workers	9.36	11.2
6. Skilled, Agricultural & Fisheries Workers	25.30	30.6
7. Craft & Related Workers	8.61	15.5
8. Plant & Machinery Operators and Assemblers	5.76	4.4
9. Elementary Occupations	39.33	18.3
10. Undefined	0.34	2.6
TOTAL	100.00	100.00

Source : Department of Census and Statistics.

* Excluding North & Eastern Provinces.

The proportion of the employee category rose marginally from 58.18 per cent in 1990 to 60.16 per cent in 1993. A remarkable development in this category is the increase in the proportion of the private sector and the decline in the public sector in line with the current policies of converting state enterprises to private companies.

Self-employed persons constitute about one fourth of total employment. The policies that were geared to induce income generating economic activities helped to grow self-employment activities.

Table 7.8

Employment Status (%)

Status	1st Quarter 1990	4th Quarter 1993
1. Employee	58.18	60.86
1.1 Public	(21.35)	(16.49)
1.2 Private	(36.83)	(44.39)
2. Employer	3.32	2.76
3. Own Account Worker	24.98	28.65
4. Unpaid Family Worker	13.52	7.73
	100.00	100.00

Source : Department of Census and Statistics.

7.4 Unemployment

The primary sources of data on unemployment in Sri Lanka are the periodical sample surveys and population censuses. The Surveys were designed to serve different socio-economic purposes. Data on employment and unemployment can be obtained from the results of these surveys. However, the definition and measurement of unemployment vary from survey to survey. Therefore, it is rather difficult to construct a consistent data series of unemployment.

Since the first quarter of 1990, the Department of Census and Statistics has been conducting a quarterly labour force survey. This survey provides a series of cross tabulations on labour force, employment and unemployment. This survey covers a nationally representative sample of about 10,000 housing units (excluding Northern and Eastern Provinces).

The estimates of unemployment derived from various surveys are given in Table 7.9. As noted earlier these data are not strictly comparable due to the

heterogeneous characteristics of the surveys with regard to concepts of unemployment, area coverage, seasonality and estimation procedures.

Table 7.9
Estimates of Unemployment

Year	Source	Estimated Nos.	Unemployment as a % of Labour Force ¹	
			DCS	CB
1963	Census of Population (DCS)	264,970	7.7	-
1963	Survey of Consumer Finances (CB)	457,700	-	13.8
1973	The Determinants of Labour Force Participation Rates (DCS)	793,000	18.3	-
1973	The Survey of Consumer Finances (CB)	1,073,000	-	24.0
1980/81	Labour Force and Socio- Economic Survey (DCS)	857,168	15.3	-
1981	Census of Population (DCS)	895,143	17.9	-
1981/82	Consumer Finances and Socio-Economic Survey (CB)	609,000	-	11.7
1985/86	Labour Force and Socio- Economic Survey (DCS)	786,170	13.2	-
1990	Quarterly Labour Force Surveys (DCS)	1,005,081	14.4	-
1991	-do-	861,680	14.7	-
1992	-do-	845,957	14.6	-
1993	-do-	830,910	13.8	-

DCS = Department of Census and Statistics

CB = Central Bank of Sri Lanka

1/ Excluding Northern and Eastern Provinces.

The unemployment problem became acute by the early 1970's largely as a result of the faster population growth during the post-war years. The trend continued until the early 1980's. The growth momentum resulting from economic liberalisation led to accelerate labour absorption in the first half of 1980's and as a result, the unemployment rate tended to decline. The pace slowed down in the second half of

1980's partly as a result of the setback in economic growth. The annual unemployment rate remained around 14.4 per cent during the period 1990-93.

The work force is projected to rise to 8.4 million by the year 2000. Accordingly, the annual addition to the labour force in the 1990's is projected in the range of 140-162 thousand. Taking into account the already existing backlog of unemployment, which is around 1 million, the economy needs to provide employment to about 2 million during the period 1994-2000 (which is equivalent to 286,000 per annum).¹

The age-wise unemployment rate for 4th Quarter, 1993 are given in Table 7.10. It can be seen that the unemployed are concentrated in the younger age groups. The unemployment rate exceeds 30 per cent of the labour force in the age groups between 10-24 years. The unemployment rates are relatively lower above 35 years. Urban unemployment rate is marginally higher than that of rural unemployment.

Table 7.10
Unemployment Rate by Age Groups for Sectors

Age Group	Sector		
	Total	Urban	Rural
All Age Groups	13.8	14.5	13.7
10 - 14 Yrs.	38.2	22.7	40.8
15 - 19 Yrs.	32.8	36.1	32.1
20 - 24 Yrs.	34.4	35.6	34.0
25 - 29 Yrs.	16.9	18.4	16.6
30 - 34 Yrs.	12.0	9.4	12.9
35 - 39 Yrs.	4.2	9.2	2.9
40 - 44 Yrs.	4.9	2.2	5.6
45 + Yrs.	2.4	2.3	2.4

Source : Department of Census and Statistics.

Table 7.11 indicates that unemployment rate is higher among females as compared to males.

1/ Rodrigo (1994)

Table 7.11
Unemployment Rate by Sex for Sectors

Set Group	Sector		
	Total	Urban	Rural
Total	13.8	14.5	13.7
Male	10.2	12.1	9.7
Female	21.0	20.3	21.1

Source : Department of Census and Statistics.

The distribution of employed and unemployed population in terms of the educational attainment is given in Table 7.12. About 28 per cent of the employed possessed GCE (O/L) or higher educational qualifications and 47 per cent had a primary education of Grade 5-9 (6-10 years). Approximately 20 per cent of the unemployed had initial primary education, while 5 per cent had no schooling. In terms of the standards of developing countries, Sri Lanka has better qualified workers.

Table 7.12
Educational Attainment of the Currently Employed and the Unemployed Persons by Sex

Labour Force Status & Sex	Total	No. Schooling	Educational Attainment			
			Grades 0 - 4/ 1-5 years	Grades 5 - 9 6-10 years	G.C.E. (O/L)/ NCGE	G.C.E. (A/L)/ HNCE & above
Employed:						
Total	100.0	5.3	19.7	46.9	16.3	11.8
Male	100.0	3.5	19.0	51.1	16.8	9.7
Female	100.0	9.2	21.1	37.8	15.4	16.5
Unemployed:						
Total	100.0	1.4	7.0	39.0	28.8	23.9
Male	100.0	2.4	10.3	44.3	24.4	18.6
Female	100.0	0.5	3.8	33.9	33.0	28.9

Source : Department of Census and Statistics.

Among the unemployed, 53 per cent had education above GCE (O/L) and 39 per cent had education of Grades 5 - 9. The proportion of less educated is smaller.

7.5 A Microlevel Analysis of Labour Market

This Section summarises the findings of a sample survey conducted in some selected Districts during the Period of this study. ¹

The Survey covered 6 Districts in 3 Provinces; Puttalam, Kurunegala (North-Western Province), Kandy, Matale (Central Province), Matara and Hambantota (Southern Province). A sample of households were selected in 22 Assistant Government Agent Divisions in the 6 Districts. The household sample consisted of 70 per cent from the rural sector and 30 per cent from the urban sector. A main objective of the survey was to ascertain the major characteristics of the labour market in selected Districts.

a. Characteristics of Population

A common characteristic observed in all the six Districts is the relatively large young population. In Puttalam and Kurunegala Districts, 50.7 per cent of the sampled population is below 24 years compared to 50.3 per cent in Kandy and Matale Districts and 45.9 per cent in Matara and Hambantota Districts. These proportions are relatively low as compared with the historical data implying a continuation of the declining trend in the size of young population. The Consumer Finances Survey conducted in 1981/82 indicated that 58.8 per cent of the total population of the country was below 26 years as compared with the ratio of 62.3 per cent in 1973. According to the present survey the mean age is 26.9 years in Puttalam and Kurunegala, 27.2 years in Kandy and Matale and 28.9 years in Matara and Hambantota. In comparison, the average age of the population for all-island was 25.4 years in 1981/82, 25.0 years in 198/79, 24.0 years in 1973 and 23 years in 1963.

In line with the above trend, the proportion of the number of persons in older age brackets has risen. The population in the age groups above 35 years accounts for 41.4 per cent in Puttalam and Kurunegala Districts, 33.4 per cent in Kandy and Matale Districts and 34.0 per cent in Matara and Hambantota Districts. In comparison, the share of population in these age groups accounted for only about 26.8 per cent of the total population of the country in 1981/82.

1/ The Survey was conducted by the Author with the help of several research assistants in 1992.

The proportion of females in the sampled population is generally higher than that of males. The proportion of females is 54.5 per cent in Puttalam and Kurunegala Districts, 54.3 per cent in Kandy and Matale Districts and 51.0 per cent in Matara and Hambantota Districts.

b. Labour Force

In this survey, the labour force was defined to include persons who are either working or looking for work in the age group of 15 - 55 years. It comprises the employed plus unemployed. Those who are not in the labour force are usually students, retired people, housewives, female heads of families and some 'discouraged workers' who are usually not considered as unemployed because they are not actively seeking work.

The sampled population was classified into two categories, namely; (a) economically active population, which is the labour force and (b) economically inactive population.

A statistical summary based on the present survey for the selected Districts is given in the following table:

Table 7.13

**Percentage-wise Distribution of the Population by
Labour Force Status**

Labour Force Status	Puttalam & Kurunegala	Kandy & Matale	Matara & Hambantota
Economically Active (Labour Force)	42.3	42.2	46.4
<i>Employed</i>	37.6	37.1	40.5
<i>Unemployed</i>	5.7	5.6	6.9
Economically Inactive	57.7	57.8	53.6
Total	100.00	100.00	100.00

It is interesting to note that there is a shift of the population from the economically inactive status to economically active status. In 1981/82, 66 per cent of the total population of the country was inactive and this ratio has declined to an

average range of about 53 to 57 per cent in 1991 in the selected Districts. This indicates that a larger proportion of the population is now available for active production work than earlier. The magnitude of employment as a ratio of total population has risen from an all-island figure of 30 per cent in 1981/82 to a range of 37 to 41 per cent in 1991. The slight increase in the unemployment as a ratio of population than earlier is due to the fact that a relatively high proportion of persons is in the labour force now than previously.

c. Labour Force by Age

The ratio of labour force to population, which is known as the labour force participation rate, has a similar pattern in all six Districts under consideration. It increases rapidly after the age of 20 years and remains at a high level upto 54 years. Thereafter it declined gradually due to factors arising from old age. The peak level of participation is in the age groups between 25 and 49 years in all the Districts. Since generation of income is tied up with employment activities, the age-wise distribution of income generally follows the age patterns of labour force participation.

The male labour force participation is relatively high in all Districts. This is due to the wider availability employment opportunities for male workers and limited supply of female labour.

d. Employment

The persons who are engaged in all kinds of income generating economic activities are defined to be included in the category of employment in the present survey.

There seems to have been a considerable increase in the proportion of the self-employment category. The share of the self-employed in employment is 47 per cent in Kurunegala and Puttalam, 37 per cent in Matale and Kandy and 38 per cent in Matara and Hambantota. These ratios are considerably higher than the ratio of 20 per cent for all island observed in the Survey Report of 1981/82. This indicates that the dependence on the organised sector, mainly on the public sector, has declined over time. The current policies that were geared to induce self-employment activities in the rural sector contributed to this favourable development.

Agriculture remains as the major source of employment generation in all the Districts. However, the proportion of persons engaged in agriculture was at a

rather high level of 63 per cent in Puttalam and Kurunegala Districts as compared with the other four Districts. The relatively low industrial growth in the two Districts is the major factor for this variation. The lower proportion of employment in the agricultural sector in the Districts of Matale, Kandy, Matara and Hambantota indicates the overall direction of the economy towards diversification. This characteristic is particularly significant in Kandy and Matale Districts where employment in agriculture is only 36.8 per cent in 1991 as compared with an all-island ratio of 47.5 per cent in 1981/82.

e. Unemployment

According to the present survey, the average rate of unemployment is estimated at 14.4 per cent for the six Districts. However, it should be noted here that the survey was conducted in the months of April - June, which is the harvesting season of the agricultural crops. Therefore, the estimated unemployment rate may reflect some of these seasonal effects. The unemployment rate in the Districts of Matara and Hambantota seems to be somewhat higher than the other Districts. On average, the magnitude of unemployment as a percentage of population is around 5.3 in these Districts.

Table 7.14
Unemployment Statistics - 1991

District	Puttalam Kurunegala	Kandy Matale	Matara Hambantota	Average
Unemployed as a percentage of Population	5.7	5.6	6.9	6.2
Unemployment as a percentage of Labour Force	14.1	13.4	15.4	14.4
Labour Participation Rate for All Ages	37.6	40.5	48.6	40.5

In terms of the age-wise distribution, the unemployment rate is high within the age groups of 20 to 29 years. The proportions of labour force in these age groups are 56 per cent in Puttalam and Kurunegala, 68 per cent in Matale and Kandy and 46 per cent in Matara and Hambantota Districts. The rate of unemployment gradually declines as the persons reach middle age.

The survey revealed that the unemployed had a fairly good background of primary education. The majority of the unemployed in the sampled population look for job opportunities in the manufacturing sector. Such persons account for 60 per cent of the unemployed in Puttalam and Kurunegala, 50 per cent in Kandy and Matale and 56 per cent in Matara and Hambantota Districts. The rest of the unemployed are seeking employment in professional and service types of activities.

There seems to be certain structural changes in job expectations over the last decade. According to 1981/82 survey, 22.1 per cent of the unemployed anticipated clerical jobs, whereas none of the unemployed covered in the present survey seeks such employment. This clearly points to the fact that job seekers have changed their attitudes from government sector-oriented white collar jobs to production generating and skilled economic activities. A further indication of this trend is that only 37 per cent of the unemployed preferred industrial work in 1981/82, whereas this ratio is more than 50 per cent in 1991. The proportion of persons seeking jobs in the sales and service sector is also relatively high in all six Districts in 1991.

Given these trends in the supply side of the labour market which are undoubtedly favourable to the development process of the country, it is important to identify the potential to create such employment in different areas of the country taking into account specific factors such as geographical location, resource endowments, credit needs, and distribution facilities.

CHAPTER 8

WAGES AND TRADE UNIONS

The majority of the employed population in Sri Lanka are wage earners. According to the Quarterly Labour Force Survey, 60 per cent of the employed were wage earners in 1993. Compensation for employees, the bulk of which is wages, accounts for about 45 per cent of National Disposable Income. Thus, wages is an important component of the overall income flows in the economy.

The estimated employment for 1993 was 5.2 million and of this, two thirds were employed in the private sector. Of them, about 2.8 million persons were employed in the unorganised (informal) private sector. The share of this sector declined from 61 per cent in 1990 to 55 per cent in 1993 reflecting an institutionalisation trend. The organised private sector employed 1.05 million persons. This sector gradually expanded from 14 per cent in 1990 to 20 per cent in 1993. The total employment in the Central Government and Provincial and local Governments amounted to about 676 thousand persons (13 per cent). Semi-Government employment, totaled 619 thousand persons (12 per cent).

8.1 Wage Determination Mechanism

Wages in Sri Lanka are determined by different wage-fixing mechanisms. In the Government sector, wages are fixed by proposals made by Government Pay Commissions or by Cabinet decisions. Private sector and public corporation wages are influenced by a composite of factors, namely, Cabinet Directives, Wages Boards, Remuneration Tribunals, Arbitration and Conciliation Procedures, Collective Bargaining, Individual Bargaining and Unilateral Employer Decisions.

The main institutional framework for wage determination in the private sector has been the Wages Boards now set up for 31 industries and trades. These Boards are responsible to fix, and from time to time revise, the minimum wages (basic wages and cost of living allowances) for different categories of workers, the hours constituting a normal working day, overtime rates and weekly annual and public holidays. These Boards cover about a million workers in estates and other trades. In addition, remuneration tribunals have been set up to fix and revise the legal minimum wages for Notaries and Attorneys-at-law, clerks and employees in specified hotels, petrol filling stations, textile shops and pharmacies in the city of Colombo.

Besides, Wages Boards and Remuneration Tribunals, there are Collective Agreements^{1/} in force which regulate the wages of employees in the private sector. With the enactment of the Trade Union Ordinance No.14 of 1935, the twin rights to organise and to bargain collectively were recognised officially. Even prior to this, however, employees and employers had organised themselves following the influences of the Russian Revolution of 1917. The twin rights were contained in the International Labour Organisation (ILO) instrument entitled the Convention on the Application of the Principles of the Rights to organise and to bargain collectively No.98 of 1949. The Industrial Disputes Act No.43 of 1950 provide for legalising the Collective Agreements that were Gazetted in terms of the Act. In the Government sector, there is no provision to enter into Collective Agreements. In the Corporation sector, Collective Agreements have been negotiated mainly with respect to State Banks and plantation Corporations. In the private sector, the highest number of Collective Agreements have been negotiated in the sectors of Mercantile, Commercial and Industrial enterprises. In addition, several Collective Agreements were entered into with private Banks.

8.2 Trade Unions and Wage Bargaining

Trade Unions have a considerable influence on the conduct of wage bargaining and on the relative wages of different groups of workers. In the absence of trade unions, wages can be assumed to adjust at a rate determined by the excess of demand for labour over supply. The intention of the trade unions is to reduce the competitive element in the supply of labour and to obtain wage increases in addition to those arising from the excess demand. Trade unions, thus, inject an inflationary factor into the system by gaining wage increases that are higher than in the absence of the unions.

A major objective of trade unions is to obtain some 'target level of real wages' for their members. Such a target implies that trade unions seek to gain wage increases sufficient to compensate for any increase in the cost of living. In view of the rising trend in cost of living, unions may attempt to attain a target level of real wages so as to compensate for any erosion in the cost of living in the future. By targeting real wages, what the trade unions attempts to achieve is to restore the real wages through raising money wages. This is known as the 'real-wage catch up' effort.

8.3 Wage Behaviour

(1) Organised Private Sector

Minimum Wage Rate Indices based on the minimum wages fixed by the Wages Boards for different trades can be used to identify the wage trends in the organised private sector (Table 8.1).

1/ A detailed analysis of collective Agreements is given in Navaratne (1987)

Table 8.1

**Minimum Wage Rate Index Numbers of Workers in Wages boards Trades
December 1978=100**

Period	Workers in Agriculture (a)		Workers in Industry and Commerce (b)		Workers in Service (c)		Workers in Wages Boards Trades (d)	
	Minimum Wage Rate Index 1	Real Wage Rate Index 2	Minimum Wage Rate Index 3	Real Wage Rate Index 4	Minimum Wage Rate Index 5	Real Wage Rate Index 6	Minimum Wage Rate Index 7	Real Wage Rate Index 8
1975 Average	50.4	60.8	72.0	86.8	-	-	52.4	63.2
1976 "	51.5	60.9	73.9	88.1	-	-	53.6	63.9
1977 "	64.8	76.3	79.5	93.7	-	-	66.2	77.9
1978 "	94.2	99.0	98.3	102.6	-	-	94.7	99.3
1979 "	123.1	116.0	111.3	105.2	113.9	107.8	119.6	112.9
1980 "	153.6	115.9	138.8	105.4	130.5	99.9	147.3	111.1
1981 "	153.9	98.3	151.0	96.2	146.4	93.2	152.2	97.1
1982 "	181.2	104.2	161.0	92.6	169.7	97.7	175.8	101.1
1983 "	198.7	100.4	163.1	82.5	177.8	89.4	188.8	95.5
1984 "	250.3	108.0	183.3	79.3	190.7	82.6	228.8	98.8
1985 "	273.5	116.6	203.9	86.9	190.7	81.3	247.9	105.2
1986 "	288.1	113.8	224.3	88.6	190.7	75.3	261.3	103.8
1987 "	302.3	110.8	256.3	93.9	196.6	72.0	277.7	101.8
1988 "	378.4	121.6	271.7	87.4	229.5	73.8	335.8	107.9
1989 "	435.9	125.7	334.9	96.6	245.9	71.0	388.1	112.0
1990 "	517.2	122.7	379.5	89.9	267.8	63.5	453.5	107.6
1991 "	577.7	122.2	459.6	97.1	336.5	71.1	518.8	109.7
1992 "	664.1	126.1	510.8	97.1	365.9	69.6	590.0	112.0
1993 "	803.7	136.6	528.7	89.8	365.9	62.2	685.8	116.6
1994 "	821.5	128.8	555.8	87.2	431.4	67.6	712.4	111.7
1995	830.9	121.1	642.1	94.1	456.7	66.5	739.5	107.7
1995 1st Qtr.	825.6	126.3	586.1	86.9	431.6	66.0	720.9	110.3
2nd Qtr.	828.3	120.0	643.3	91.0	435.5	63.3	738.8	106.4
3rd Qtr.	835.5	120.7	677.0	97.8	472.8	68.3	750.5	108.4
4th Qtr.	834.0	117.1	681.7	95.7	487.2	68.4	752.6	105.7

Source: Labour Department and Central Bank of Sri Lanka.

Note: The Index numbers are calculated on fixed weights based on the numbers employed as at December 31, 1978. The wage rate used in the calculation of Index numbers are minimum wages from different qaoes fixed by the Wages Boards. Figures prior to December, 1978 have been spliced to the new Index and are not strictly comparable.

- (a) The Index refers to wage rates of tea growing and manufacturing, rubber growing and manufacturing, coconut, cocoa, cardamoms and pepper growing trades only.
- (b) Includes baking, brick and tile manufacturing, coconut manufacturing, printing textile, tyre and tube manufacturing, coir mattresses & bristle fiore export, hosiery manufacturing, engineering, manufacturing, match manufacturing, biscuit & Confectionary, tea export and rubber export trades only.
- (c) This is a new series of Index number computed with the divisions and 1978 are not available. This includes cinema, motor transport and nursing homes trade only.
- (d) Combined Index for workers in Agriculture; workers in Industry & Commerce and Services.

The combined nominal wage index for workers in agriculture, industry and commerce and services has generally moved along with the consumer Price Index during 1978-93 and as a result, the combined real wage index has remained stable over the period. This indicates that the nominal wages have increased to compensate for inflation, thus effecting the 'wage-catch up'.

However, the situation becomes different when sectoral trends are considered. The real wages in workers in agriculture (tea growing and manufacturing, rubber growing and manufacturing and coconut, cocoa, cardamoms and pepper growing trades) risen rapidly. In contrast, workers in the sectors of industry, consumer and services experienced a deterioration in their real wages. Agricultural workers obtained considerable real wage increases in 1979 and in 1988. The rise in their real wages has been steady since 1989. The improvement of real wages in the Agricultural sector in comparison with other sectors shows the bargaining strength of the trade unions, particularly those in tea plantations.

(2) Unorganised Private Sector

Data on wages in the unorganised sector for selected activities can be obtained from the Countrywide Data Collection System of the Central Bank. These nominal wage rate data has been compiled since 1978 for the sectors of Paddy, Tea, Rubber and Coconut cultivation and building construction. It is significant to note that real wages with respect to all sub-sectors have improved over the period 1978-93. This indicates that workers in the unorganised sector have been able to protect themselves against rising prices despite there being no mechanism to prevent erosion of real wages.

(3) Government Sector

Wages for Government employees have been influenced mainly by overall pay reviews by periodical Salaries Commissions and Cost of Living adjustments.

Upward salary revisions recommended by Salaries Commissions were implemented in the years 1955, 1974, 1982, 1986 and 1988.

The system of Cost of Living Adjustment (CLA) was introduced during the Second World War. It was expected to use as an instrument to safeguard the employees against inflation on the basis of a predetermined formula. The policy towards wage indexation changed from time to time depending on the inflationary trends. The indexation was suspended in 1953 due to low inflation and the CLA component remained frozen until 1967. Following the currency invalidation in

1967, an Across the Board Devaluation Allowance was introduced in that year through a Cabinet decision for the first time. Inflation accelerated in the 1970's and as a result, decreases allowances were introduced on 8 occasions during the decade (i.e. Dec. 1972, Oct. 1973, April, 1974, Feb. 1975, January 1976, Dec. 1977, January 1979, and Sept. 1979). Since most of these controls were abolished with 1977 economic reforms, the general price level has varied more freely since then. This necessitated more cost of living adjustments to wages and 7 such revisions were implemented in the 1980's (i.e. Nov. 1980, March 1983, Sept. 1983, March 1984, Sept. 1984, Jan. 1985 and Jan. 1990). An Administrative Reforms Committee was appointed in 1987 to examine the administration mechanism in the Government Sector.

Wage Indices for Government Employees indicate that real wages have been maintained sufficiently in the case of non-executive officers and minor employees. But real wages of school teachers have deteriorated over the period except for a few years.

8.4 Industrial Policy and Labour Relations

Since the economic reforms of 1977, a more conducive economic climate has been created to promote industrial production in the private sector. In order to facilitate the industrialisation process, the Government issued a Strategy for Industrialisation in 1989 (Ministry of Industries). Under these policies, a series of inducements have been granted to encourage domestic savings and to promote local and foreign investments. Other facilities include granting of up-front assistance, provision of infrastructure, improving management and raising productivity.

Several proposals pertaining to the labour market and industrial relations are given in the Strategy for Industrialisation document as follows:

- (1) The plethora of labour legislation relating to matters such as termination of employment, industrial disputes, leave, superannuation benefits, wages and industrial safety creates confusion and uncertainty. It is proposed to codify the labour laws so that both employees and employers will be in a better position to know their rights and obligations.
- (2) The labour laws existing at present are weighted in favour of those who are already in employment and acts as a disincentive to the creation of new employment. Further, the present system of fixing minimum wages and the

tendency to push up wages of unskilled workers is unfair by skilled workers. The differential in wages between the skilled and unskilled workers is marginal. This situation will be corrected in order to make the position of skilled workers more attractive.

- (3) The Termination of Employment of Workmen (Special Provision) Act of 1971 will be replaced, since it prolongs inquiries which frustrate both the employees and employers. Measures will be taken to expedite enquiries within a limited time frame in terms of the provisions of the Industrial Disputes Act.
- (4) The Fuel Conservation Act of 1978 will be replaced to enable industries to have flexible working days.
- (5) A study will be undertaken to review the holidays and non-working days in the Sri Lankan calendar, with a view to providing more working days. Appropriate compensatory measures will be provided for any revision of holidays.
- (6) As far as total remuneration for production is concerned, greater emphasis will be given to the variable elements, such as incentive payments and profit sharing schemes, that wages and remuneration are adjusted in relation to performance and profitability.

A major thrust of these policies is to raise labour productivity in the face of increased domestic and foreign competition. For this purpose, the policy statement gave high priority to manpower development and training in addition to the above proposals. Proposals (2) and (6) above focuses on the necessity to evolve a linkage between productivity and wages.

The market-oriented industrialisation strategy calls for a fresh approach to industrial relation. Cooperation of the workers too is essential to maintain industrial peace and to safeguard competitive advantage for exports. A rise in wages, for instance, would erode the export competitiveness. Industrial disputes would motivate foreign entrepreneurs to divert their investments to countries that enjoy industrial peace.

8.5 Labour Productivity and Wages

An underlying principle of wage behaviour is that money wages should not grow faster than the average rate at which productivity was increasing in the

economy.¹ Labour productivity can be defined as the ratio of output to labour input.

As productivity increases, the amount of labour required is less. Therefore, if wages are rising as fast as productivity, the labour cost of producing an item remains constant. If prices are fixed as a mark-up on labour costs, prices could not rise if wages were rising no faster than productivity.

Let us now examine the relationship between the output and labour inputs. On the basis of the employment data derived from various surveys and censuses, the estimate is done on, the elasticity of output with respect to labour inputs and productivity in terms of output per man. The results are presented in Table 8.2.

Table 8.2
Sri Lanka: Labour Output Elasticity and Productivity

Activity	Elasticity			Output per man (Rs. '000) at 1982 prices			
	1963-71	1971-81	1981-90	1963	1971	1981	1990
1. Agriculture, Forestry & Fishing	1.77	2.37	2.16	8.8	9.5	13.1	10.5
2. Mining & Quarrying	0.02	0.10	0.07	13.8	22.1	55.7	24.2
3. Manufacturing	0.46	0.41	0.71	22.2	30.9	31.2	25.9
4. Construction	0.17	0.15	0.13	32.4	53.7	65.4	47.8
5. Electricity, Water & Sanitary Services	0.05	0.02	0.02	7.9	39.7	65.3	125.4
6. Trade	0.49	0.53	0.60	12.0	18.2	23.2	28.3
7. Transport	0.21	0.29	0.28	53.3	63.2	93.5	107.4
8. Finance	0.03	0.07	0.09	40.0	47.9	73.0	132.4
9. Other Services	1.28	1.22	1.38	4.3	7.5	10.2	13.9
GDP	4.56	5.38	5.69	12.2	16.2	22.0	21.7

1/ This was focussed in New Economies adopted in the United States during the Kennedy administration in the 1960's. New Economies was based on the Keynesian approach, which addressed the problems of unemployment.

The elasticities indicate the percentage change of sectoral production in response to changes in labour. The elasticity is highest in the Agriculture implying that an increase in labour inputs has a greater effect on the output of this sector. This can be expected due to the high level of labour intensity in Agriculture as compared with other sectors. The labour elasticity in Agriculture increased considerably in 1971-81 reflecting the productivity increases and showed a marginal decline in 1981-90. Output per man is considerably high in the sectors of Finance, Electricity, Water and Sanitary Services and Transport. This indicates that these sectors employ less labour. A significant characteristic of these sectors is the rapid rise in productivity after 1981. The improvement in productivity can be partly attributed to the technological improvements resulted from the liberalisation. Given the high priority to industrialisation, it is rather disappointing to note that labour productivity in the Manufacturing sector which showed a marginal improvement up to 1981, declined since then. A similar trend can be observed in the case of GDP.

Year	1961-70	1971-80	1981-90	1991-00
1. Agriculture	0.85	1.15	1.05	0.95
2. Manufacturing	0.45	0.55	0.45	0.35
3. Services	0.35	0.45	0.55	0.65
4. Finance	0.15	0.25	0.35	0.45
5. Electricity, Water & Sanitary Services	0.10	0.20	0.30	0.40
6. Transport	0.15	0.25	0.35	0.45
7. Other Services	0.25	0.35	0.45	0.55
8. GDP	0.55	0.65	0.75	0.85

CHAPTER 9

INFLATION

A rise in the general level of prices is referred to as inflation. Persistent inflation has adverse effects on the living standards of the people and on all kinds of economic activities. Inflation deteriorates the real incomes and thereby restrains consumption. It also inhibits savings and investment. The rising prices also weakens the export competitiveness of the country.

9.1 Inflationary Trends

Prior to the first oil crisis in 1973, the annual average rate of inflation measured in terms of the CCPI was around 5 per cent. Largely as a result of the crude oil price increase, the rate of inflation rose to 9.6 per cent in 1973 and to 12.3 per cent in 1974. Inflation slowed down at the rate of 6.7 per cent in 1975. In the subsequent 2 years, the general level of prices rose only by 1.2 per cent.

The reforms adopted in 1977 necessitated a different approach towards prices. These reforms were intended to correct structural imbalances in prices that emerged largely as a result of administrative price controls of the earlier regime. In addition to the removal of price controls, the policy reforms also initiated to correct price distortions in foreign exchange and interest rates. Accordingly, the exchange rates and interest rates were allowed to be determined in the free market with minimum intervention by the authorities to avoid any abrupt fluctuations.

The removal of most price controls and exchange rate depreciation led to a rise in the inflation rate to 12 per cent in 1978. Since then, inflation remained at double digit levels until the end of 1984. A major factor that contributed to the acceleration of inflation during that period was the monetary expansion. The broad money supply (M2) increased at an annual rate of 26 per cent during the period 1981-84. Larger

Table 9.1
Colombo Consumers' Price Index
(Percentage Changes)

Period	All Items	Food	Clothing	Fuel & Light	Rent	Miscell- aneous
1952-60	0.4	0.1	-0.4	0.2	2.1	2.1
1960-70	3.0	3.1	3.9	3.1	0.8	2.7
1971	2.7	1.8	5.6	3.5	0.0	10.6
1972	6.3	6.0	12.8	3.6	0.0	0.0
1973	9.6	12.7	13.8	12.7	0.0	0.2
1974	12.3	14.1	9.9	34.4	0.0	5.0
1975	6.7	7.7	1.8	7.3	0.0	7.6
1976	1.2	-1.1	1.7	11.9	0.0	6.2
1977	1.2	0.6	5.7	-2.9	0.0	2.3
1978	12.1	16.8	1.1	1.8	0.0	7.9
1979	10.8	10.9	2.2	25.3	0.0	12.3
1980	26.1	29.0	3.8	71.7	0.0	16.4
1981	18.0	17.6	7.5	36.2	0.0	17.7
1982	10.8	12.7	6.2	6.3	0.0	9.1
1983	14.0	12.4	6.3	33.2	0.0	15.0
1984	16.6	18.1	5.6	17.9	0.0	14.6
1985	1.5	0.1	5.4	3.9	0.0	5.5
1986	8.0	7.2	15.5	1.2	0.0	14.4
1987	7.7	8.7	7.0	0.8	0.0	8.5
1988	14.0	15.1	4.7	13.0	0.0	14.1
1989	11.6	10.3	16.7	12.0	0.0	15.8
1990	21.5	23.3	36.8	12.5	0.0	18.7
1991	12.2	11.9	1.2	16.4	0.0	12.2
1992	11.4	11.9	6.7	3.6	0.0	15.1
1993	11.7	11.2	8.2	17.0	0.0	13.0

Source: Department of Census and Statistics

the money supply. Price pressures emerged also from the external front in the wake of the second oil shock of 1979-80.

Inflation decelerated at 1.5 per cent in 1985. This can be partly attributed to the slow expansion of broad money at the rate of 11.5 per cent. The monetary expansion slowed down further in 1986. The rate of inflation was around 8 per cent in 1986 and 1987.

Inflation picked up again in 1988 rising to 14 per cent. The major factors responsible for the price acceleration were the drought conditions, civil disturbances, upward revision of BTT and increase in electricity tariffs.

Inflation continued to remain high throughout the period 1988-93. The rapid increase in the money supply at the rate of 18.6 per cent per year during that period generated inflationary pressures in the economy. Monetary expansion was resulted from increased foreign capital inflows and domestic credit.

The money supply rose by about 23 per cent and overall liquidity remained high in 1994. However, the rate of inflation came down to about 9 per cent mainly due to the reduction of administered prices of several consumer goods including wheat flour, bread, lentils and kerosene oil. Adequate supplies of certain agricultural products also helped to bring down the general price level.

9.2 Causes of Inflation

Different schools of thought have given different explanations on the origins of inflation over the years. The 'orthodox' approach of inflation is based on the Phillips Curve in which hypothesises a reversed L-shaped aggregate supply Curve and a downward sloping aggregate demand curve. In the original Phillips Curve (1958), it was asserted that wage changes were caused by excess demand which could be measured by the inverse of the unemployment rate. It was argued that the rate of change of money wages will be equivalent to the expected rate of price changes plus an adjustment with respect to exceeded demand for labour.

Monetarists led by Friedman argued that the Phillips Curve associated with Keynesian theory cannot explain the problem of inflation, especially the acceleration of inflation. According to them, inflation is a monetary phenomenon. Thus, the rate of growth and the acceleration of the money supply explain the rate of inflation and its acceleration, respectively.

The above theories were based on the experiences of industrial countries. In view of the specific economic characteristics in developing countries, the validity of the standard theories in explaining inflation in these countries was questioned by some economists in the early sixties.

Based on the experience of Latin America, 'structuralists' considered inflation as the result of structural bottlenecks in the economy. These bottlenecks are (a) inelastic supply of foodstuffs, (b) foreign exchange bottlenecks and (c) financial constraints. Price increases in a particular sector (e. g. food) raise the general price level. If wages are tied up with consumer prices, wages in other sectors (say industry) may tend to rise leading to wage-price spiral. The monetarists counter-argued that the structural inelasticity of food supplies, is not structural, but is an outcome of the administrative controls imposed by the Government.

Inflation in Sri Lanka can be considered as a process stemmed from a combination of above factors. There appears to be a close relationship between monetary expansion and inflation indicating the characteristics of 'demand pull' inflation. 'Cost push' effects are reflected in the correlation between money wages and inflation. In this case, inflation encourages the workers to obtain higher money wages, on the one hand and wages tend to accelerate inflation through the effects on cost of production, on the other. As regard agricultural commodities, weather conditions are a major determinant of their prices. Since Sri Lanka depends heavily on imports, changes in import prices in foreign markets and exchange rate movements also affect the general price level.

PART III

DOMESTIC AND FOREIGN FINANCE

PART III

DOMESTIC AND

FOREIGN

FINANCE

CHAPTER 10

MONETARY POLICY IN THE OPEN ECONOMY

Several significant reforms in monetary policy have taken place after the liberalisation of the economy in 1977. Today the economy is free of administrative controls to a considerable extent and market forces play a key role in regulating the economy. Further liberalisation of the economy has taken place since 1989 and this policy package consisted of financial sector reforms, removal of onerous exchange control procedures and regulations, flexible exchange rates and a movement away from the state management and ownership of enterprise. In this background, the Central Bank has reformulated its monetary policy to place a greater reliance on market based policy instruments rather than on direct controls that had been used previously.

Before the introduction of the liberalisation measures initially in 1977, the Central Bank had relied heavily on direct monetary controls, and these included administered interest rates, credit rationing and ceilings and directives to the commercial banks. The experience during that period showed that such direct controls discouraged savings and investment and discouraged commercial banks to participate more actively in financing development and acted as a setback to the development of the money and capital markets.

Greater use has been made of interest rates in contrast to the methods of monetary regulation used in the pre-open economy period. Open market operations in short term securities have been used in recent years to control liquidity in the market and to influence the level of interest rates. Open market operations were not so extensively used before 1980 and to some extent this may have been the outcome of limitations in the money market for such operations which is a feature common to developing countries. The orthodox theory says that a developed money market is necessary for effective open market operations. In a country like Sri Lanka, the Central Bank has a duty to build up the market and to use even the limited potential available in the market to the maximum extent. As distinguished from the organised money market, a very large unorganised money market exists in the country.

Steps taken by the Central Bank, particularly, since the second half of nineteen eighties to develop the money market had produced some results. For instance, the introduction of regular Treasury Bill auctions helped to produce market determined competitive rates for the bills, thus making these bills more attractive to non-bank

investors. After 1987 with more attractive rates of interest offered, the Central Bank holdings of Treasury Bills tended to come down substantially.

Another significant development in monetary policy in a liberalised economy is the freeing of interest rates, and giving opportunities for the markets to determine the levels. In the earlier controlled regime, interest rates on deposits and on credit extended by commercial banks and other financial institutions were kept low by administrative means. In the unorganized sector, there is no State intervention and regulation, but private money lenders have always charged exorbitant interest rates from borrowers. There was no way in which the Central Bank could influence interest rates in the unorganised sector and the other terms on which credit is given because it had no channels of access to this sector. The high interest rates in the unorganized money market often do not promote the right types of productive and viable investments and much of the credit is given for consumption.

As a further step, in shifting the emphasis from more direct regulation to market-based monetary controls, the Central Bank in 1991 initiated to phase out its refinance schemes. Although these schemes were effective in providing credit to priority sectors, they tended, to some extent, to nullify the effects of monetary policy partly because refinance involved the direct disbursement of funds from the Central Bank. Besides, these schemes caused distortions in the financial market, since certain categories of privileged borrowers were able to get credit at subsidised interest rates.

Monetary measures have come to play a crucial role in providing the right incentives in the open economy. These measures have contributed to activate the money and capital markets and make them function more effectively. Activities in the money and capital markets have expanded considerably after 1990 with the further liberalisation of exchange controls and the wide range of fiscal incentives given to both foreign and local investors, under broad financial sector reforms. In this background, the Central Bank has taken suitable monetary measures to support the ongoing liberalisation programme.

Moreover, the monetary authorities have had to deal with problems like credit indiscipline, loan delinquency and insolvency of financial institutions. Since 1989, a series of steps have been taken to overcome these problems. They included the enactment of credit recovery laws and strengthening of the Central Bank's supervision of commercial banks and non-bank financial institutions.

10.1 New Monetary Control Framework

The main objective of monetary policy is to control the availability and cost of liquid assets in the economy so as to facilitate achieving certain macroeconomic goals including faster economic growth, high level of employment, low inflation and balance of payments equilibrium. Money may be treated as the most liquid asset in any economy. However, assets such as time and savings deposits of commercial banks became easily convertible into currency, and therefore, they can also be treated as a part of the money supply. The concept of money supply may be extended to include other assets like deposits in non-bank financial institutions, eg., finance companies. In this context, it is essential to identify the correct composition of money supply to control the overall liquidity of the economy effectively. In Sri Lanka, two concepts of money supply (narrow and broad) are used at present for monetary policy purposes. i.e. M 1 and M 2 (Table 10.1).

Table 10.1
Composition of Money Supply

End of Period	Narrow Money (=M1)	Quasi Money	Broad Money (=M2)	M1 as % of M2	M2 as Ratio of GDP
1970	1967	1148	3115	63.1	0.23
1971	2149	1286	3435	62.6	0.24
1972	2482	1493	3974	62.4	0.26
1973	2778	1376	4154	66.9	0.23
1974	2946	1623	4568	64.5	0.19
1975	3088	1669	4757	64.9	0.18
1976	4166	2155	6321	65.9	0.21
1977	5366	3351	8717	61.6	0.24
1978	5936	4956	10892	54.5	0.26
1979	7669	7388	15058	50.9	0.29
1980	9428	10432	19860	47.5	0.30
1981	10024	14422	24446	41.0	0.29
1982	11760	18750	30510	38.5	0.31
1983	14748	22509	37257	39.6	0.31
1984	16824	26603	43427	38.7	0.28
1985	18761	29648	48409	38.8	0.30
1986	21179	29681	50860	41.6	0.28
1987	25083	33252	58335	43.0	0.30
1988	32379	35567	67946	47.7	0.31
1989	35338	41096	76434	46.2	0.30
1990	39878	51139	91017	43.8	0.28
1991	47055	65043	112098	42.0	0.30

Source: Central Bank of Sri Lanka

- Definitions: Narrow Money (M1) = Currency and demand deposits by the public.
- Quasi Money = Time and Savings deposits held by the public.
- Broad Money (M2) = M1 + Quasi Money

The main instruments of monetary policy that are used to control the money supply can be classified as follows:

1. Market intervention
 - 1.1 Open Market Operations
 - 1.2 Bank Rate
2. Portfolio Limits
 - 2.1 Reserve Requirements
 - 2.2 Credit Ceilings
3. Other Instruments
 - 3.1 Prior Import Deposits
 - 3.2 Moral Suasion

Of these instruments, open market operations, Bank rate and reserve requirements are market-oriented and are indirect types of controls. Credit ceilings, prior import deposits and moral suasion are direct controls. It is widely accepted now that direct monetary instruments tend to create distortions in the financial market and eventually their effectiveness in monetary control is likely to get eroded as discussed above. In contrast, indirect instruments of monetary policy are found to be more efficient in the management of liquidity in the economy. Traditionally most developing countries have depended on direct controls, mainly due to the lack of developed money markets. However, many of these countries have taken action in recent years to move away from direct controls and reorient their financial systems so that there will be more scope for indirect regulation.

Let us explain each of these monetary policy instruments briefly.

- (a) Open market operations mean the buying or selling securities (usually government paper) by the monetary authorities to affect interest rates and the money supply. For instance, the sale of government securities by the Central Bank will lead to a reduction in cash assets of both the banking system and the public and will also result in an increase in interest rates. Purchase of securities by the Central Bank will have the opposite effect.
- (b) The Bank Rate, at which the Central Bank offers advances to commercial banks for their temporary liquid purposes, is used to influence cost of credit. For instance, an increase in Bank rate raises the cost of credit and thereby reduces the availability of liquidity and vice versa.
- (c) The minimum cash reserve ratio against deposits to be maintained by commercial banks is always stipulated by law. The Central Bank can influence the credit creation of commercial banks by changing this ratio, affecting the credit multiplier.¹ An increase in the reserve requirements reduces the ability of the banks to create credit and vice versa.
- (d) The Central Bank can also impose a ceiling on overall lending or on lending for specified purposes. They may also take the form of margin requirements, i.e. requiring borrowers to finance a part of their credit needs themselves.
- (e) Under prior import deposits, importers are required to maintain a deposit with the banking system for a specified period as a part of the funds needed for import payment.
- (f) Moral suasion means that the Central Bank requests commercial banks and other financial institutions to conduct their operations in accordance with the general views of the monetary authority.

The monetary policy instruments are linked with ultimate macroeconomic goals through intermediate targets, such as market interest rates and availability of money and credit. This transmission mechanism which links monetary policy instruments, intermediate targets and ultimate targets, varies over time, depending on the type of financial system in existence. The monetary authorities control the

1/ The multiplier can be expressed as $K = (c+1)/(c+r)$ where c denotes currency (outside banks) - to-deposits and r denotes the banks' reserves-to-deposit ratio.

total money stock ¹ by influencing the monetary base and money multiplier. The monetary base consists of currency held by banks, currency held by the public and reserves of commercial banks with the Central Bank. The monetary base is affected by net foreign assets of the Central Bank's net claims on government and net claims on financial institutions.

In Sri Lanka, the framework of monetary control in the present liberalised financial system differs from that in the pre-reform system. In a closed economy model with fixed exchange rates and a restrictive financial system, the control of money supply is relatively less complex and the link between monetary policy and aggregate demand is more direct. The monetary authorities are able to determine the money supply more effectively in such a system by controlling (a) its net foreign assets through foreign exchange budgeting; and (b) credit from the Central Bank through direct controls.

These direct controls include interest rate regulations, reserve requirements and directed credit. These were the main instruments of monetary policy used in the previous closed system. In general, the narrow money supply was considered the major intermediate target in that system since there was little scope to develop other financial assets in a restrictive system. This type of monetary framework was in operation in Sri Lanka prior to 1977.

With the opening up of the economy in 1977, and the further liberalisation measures put into effect since 1989, these earlier monetary policy instruments have become ineffective and unproductive. With the policy reforms, the monetary policy became a part of the overall policy framework geared to implement substantial macroeconomic adjustments. These adjustments were supported by the Structural Adjustment Facility and other financial assistance programmes of the IMF and the World Bank. The economy is now free of exchange controls to a considerable extent and the exchange rate is more flexible. The financial sector has been considerably liberalised. In such a system the monetary control and the transmission mechanisms have become more complex. The Central Bank has found it difficult to control its own net foreign assets due to foreign exchange relaxation. Similarly, it has found it difficult to contain net claims on the government due to deficit financing. Thus, the

1/ The total money stock (=M) can be defined as follows:

$$M = mH$$

where

m = money multiplier

H = Monetary Base (or high powered money or reserve money)

Central Bank has been able to control the monetary base only through its influence on net claims on financial institutions. In this context, the Central Bank had to adopt a new monetary control framework to deal with excess liquidity in the economy without disturbing the increased level of economic activities that took place after the liberalisation.

Until early 1988 an administered structure of interest rates was used as a major monetary policy instrument. Since then, the emphasis has been shifted towards open market operations. Under these new arrangements, the intermediate targets are different from those in the pre-reform era. In the previous system the narrow money supply (=M1) was used as a major intermediate target. Banking innovations with regard to time and savings deposits in recent years have made those deposits as liquid as demand deposits. Therefore, the Central Bank decided in 1980 to adopt the concept of broad money supply (=M2) so as to include quasi money, which consists of time and savings deposits of the public held with commercial banks (Table 10.1). Thus, broad money supply has become a major intermediate target of monetary policy in addition to the narrow money supply.

Given the above framework of monetary control and intermediate targets, the Central Bank introduced a National Credit Plan (NCP) in 1981. The main objective of the NCP was to set out monetary and credit targets on the basis of forecasts relating to variables such as net foreign assets, net credit to government and the private sector, economic growth, the balance of payments, fiscal performance and inflation. The NCP has been prepared continuously on an annual basis and the Central Bank has used these credit plans as a guide to monetary management.

10.2 Interest Rate Liberalisation

A major element of monetary policy reforms adopted since 1977 has been the liberalisation of interest rates. In the pre-reform period, the money and capital markets were fragmented into two sectors; an organised sector consisting of financial institutions (mainly banks) and an unorganised sector with informal credit institutions and private money lenders. Interest rates remained high in the unorganised sector. In contrast, interest rates in the formal sector were kept at low levels by means of interest rate ceilings, subsidised credit allocations and high reserve ratios. Meanwhile, the banks found it difficult to attract deposits due to relatively low interest rates. Therefore, they had to ration their credit, giving priority to large scale established enterprises. Since the small scale borrowers were neglected by official institutions, they depended on the unorganised sector ('curb' market) at high cost.

This type of money and capital market segmentation has been characterised as financial repression by Mckinon (1973) and Shaw (1973). According to this school of thought, the removal of financial repression through financial liberalisation policies would make the returns on the assets with official financial institutions (mainly time and savings deposits with commercial banks) more attractive, and therefore, more funds would flow to this segment of the capital market. As a result, these institutions would be able to reduce their credit rationing and would disburse cheaper credit to smaller firms that had been neglected earlier. With the expansion of credit provided by formal financial institutions, the curb market could be phased out gradually. It is expected that this would lead to an improvement in the overall efficiency of resource allocation since the distribution of credit in the organised sector will be based on the rates of return rather than on administrative rules.

As part of the broad economic reforms, action was taken in 1977 to make use of interest rates more effectively. A major feature in the period before the reforms was the existence of low interest rates through administrative measures. This inflexible interest rate structure not only discouraged savings and investment but also weakened the effectiveness of interest rates as an instrument of policy. Since interest rates were not allowed to adjust for domestic inflation, real interest rates remained generally negative prior to 1977 (Table 10.2).¹

In an effort to raise market interest rates, Bank rate was raised from 6.5 per cent to 10 per cent in 1977. Following this increase, interest rates in commercial banks and other savings institutions rose substantially. Commercial banks raised their interest rates on fixed deposits for 12 months or more from 7 - 7.5 per cent to 14-15 per cent; rates on short term deposits were also raised considerably. The savings deposit rates of commercial banks rose from 5.5 per cent to 7.2 per cent. The National Savings Bank raised its rates on fixed deposits of 6 months or above from 7.5 per cent to 12-18 per cent. Interest rates on deposits held by finance companies rose by 1-4 percentage points to a range of 9-20 per cent. Corresponding increases took place in interest rates offered on government securities. The long term bond rate rose from 9 per cent to 10 per cent and the Treasury Bill auction rate went up from 5 per cent to 9 per cent in late 1977.

1/ Real interest rate is defined here as the difference between interest rates on 12 months' fixed deposits of commercial banks and rate of change of the Colombo Consumer Price Index.

Table 10.2
Interest Rates

(Percentages)

End of Period	Bank Rate	Deposit Rates	Rate of Inflation	Real Rate of Interest
1970	5.5	4.5	5.90	-1.40
1971	6.5	4.5	2.68	1.82
1972	6.5	4.5	6.27	-1.77
1973	6.5	4.5	9.68	-5.18
1974	6.5	4.5	12.33	-7.83
1975	6.5	7.3	6.73	0.52
1976	6.5	7.3	1.21	6.04
1977	10.0	14.5	1.25	13.25
1978	10.0	14.5	12.11	2.39
1979	10.0	14.5	10.76	3.74
1980	12.0	20.0	26.12	-6.12
1981	14.0	21.0	17.98	3.02
1982	14.0	18.5	10.84	7.66
1983	13.0	19.0	13.96	5.04
1984	13.0	18.0	16.64	1.36
1985	11.0	15.0	1.46	13.54
1986	11.0	11.3	7.98	3.27
1987	10.0	11.3	7.72	3.53
1988	10.0	12.3	13.99	-1.74
1989	14.0	15.8	11.57	4.18
1990	15.0	16.0	21.49	-5.49
1991	17.0	16.0	14.00	2.00

Note: The deposit rates shown here are the average of maximum and minimum values of commercial banks' deposit rates for 24 months. Real interest rate is the difference between the deposit rate and inflation rate.

The upward movement of interest rates helped to maintain positive real interest rates throughout the period 1977-1991 except in 3 years when inflation was excessive. The Central Bank took action to further raise interest rates in 1980 and 1981 in order to deal with excess liquidity in the economy which resulted in a sharp increase in prices. In April 1980, Bank rate was raised from 10 to 12 per cent and the period rate structure was increased from 15-25 per cent to 20-30 per cent. This was followed by increases in deposit and lending rates of commercial banks and other lending institutions. The Treasury Bill rate rose from 9 per cent to 13 per cent and the rate on government securities increased from 10 per cent to 16 per cent. In August 1981, the Central Bank increased Bank rate from 12 per cent to 14 per cent and penal rates from 20-30 per cent to 21-30 per cent. The real interest rate became negative in 1980 irrespective of the increases in nominal interest and this was attributed to high inflation.

A significant development that followed the interest rate liberalisation was the tendency for interest rates to fluctuate depending on demand and supply in the market. In 1982, for instance, commercial banks reduced interest rates on all classes of time deposits since liquidity rose sharply due to a substantial growth of deposits and a significant fall in the demand for credit from the private sector. It is significant that this change was implemented by the commercial banks in the absence of any change in Bank rate. The downward adjustment of deposit rates continued until mid 1988.

In 1988, interest rates started to move upwards reflecting the reduced supply of funds in the market and growing inflationary pressures. The rise in interest rates was more prominent where interest rates were determined largely by market forces. In the Treasury Bill market, rates became increasingly market determined with only minor interventions by the authorities. In the latter part of 1988, the Treasury Bill rate rose significantly due to increased demand for funds by the government. Accordingly, the weighted annual average yield on Treasury Bills increased from 10.77 per cent at the end of 1987 to 18.86 per cent by the end of 1988. In response to these developments in the primary Treasury Bill market, the discount and rediscount rates in the secondary Treasury Bill market rose from 7.26 and 11.26 per cent respectively, at the end of 1987 to 18 and 23 per cent per annum by the end of 1988.

Along with the above movements, in 1988, interest rate increases took place in the banking system. The inter-bank call money market rate rose significantly from a range of 11-14 per cent per annum at the end of 1987 to 16-21 per cent per annum by the end of 1988. Interest rates on fixed deposits of commercial banks and Certificates of Deposit were also raised in the latter part of the year.

Interest rates continued to be responsive to market forces in 1989. Due to inflationary pressures in the economy, interest rates moved upward during the year. Bank rate was raised from 10 to 14 per cent in June 1989 as a stabilisation measure. A heavy demand for funds by the government coupled with inflationary pressures tended to push up the yields on the Treasury Bills. The weighted average yield on 12 months Treasury Bills rose from 18.8 per cent at end of June 1989 to 19.1 per cent at the end of the year. The interest rates in the inter-bank call money market fluctuated in the third quarter of 1989 and settled down at a slightly lower point by the end of the year. The minimum and maximum rates of commercial banks' 12 month deposits increased from a range of 15.5 per cent per annum at the end of 1988 to a range of 11 to 25 per cent by end of 1989. Similar increases in deposit rates were evident in the other financial institutions.

Interest rates remained at high levels by 1990 due to acceleration of inflation and the increased demand for funds. Meanwhile, Bank rate was raised from 14 to 15 per cent in July 1990. The rates in the Treasury Bill market rose, particularly during the second half of the year. The weighted average yield on Treasury Bills increased from a range 15.4 - 16.9 per cent per annum in May 1990 to 17.4 - 18.4 per cent by the end of the year. Discount and rediscount rates in the secondary Treasury Bill market also rose. Interest rates in the inter-bank call money market fluctuated widely in 1990 and reached the highest range of 19-30 per cent per annum in August 1990. The minimum and maximum rates on 12 months fixed deposits declined in March 1990, but increased thereafter. The National Savings Bank raised its savings and fixed deposit rates by 2 percentage points per annum in July 1990.

With a view to containing the high rates of monetary and credit expansion, the Central Bank took further monetary measures. In January 1991, Bank rate was raised from 15 to 17 per cent. However, a falling trend of interest rates in certain markets in the subsequent months was observed and this could be mainly attributed to the decline in the rate of inflation. For instance, interest rates in the primary and secondary Treasury Bill markets declined from an average range of 17.4 - 18.4 per cent at the end of 1990 to 16.3 - 17.6 by June 1991. Interest rates in the call loans market fluctuated considerably as in the recent past, reflecting varying liquidity positions of commercial banks.

The low level of financial savings has been a major setback to economic growth in many developing countries, including Sri Lanka. This situation arose due to a number of factors including poor money and capital markets, negative real interest rates and distortions in the financial markets. Most of these factors resulted from administered interest rates that were in operation during the regime of economic

controls. Liberalisation of interest rates helped to eliminate these factors and provided an impetus to the growth of savings.

A proxy that can be used to measure financial savings is the magnitude of broad money which includes monetary assets and quasi monetary deposits with the banking system (=M2). As shown in Table 10.1, financial savings (=M2) as a ratio of GDP declined considerably during the period 1971 - 75 and this was mainly due to negative real interest rates. The situation improved marginally in 1976 with a rise in the real interest rates.

The nominal interest rates rose dramatically in 1977 after the monetary policy reforms which brought about positive real interest rates. These rates reached a peak in 1981 and continued to remain high until about 1984, with positive real interest rates, except in 1980. Between 1985 and 1988, the rates remained at a relatively low level due to an increase in the supply of funds in the market. However, real interest rates took positive values in that period. The nominal interest rates rose again in 1989 and they have continued to remain high. A fall in real interest rates was experienced only in 1990.

It is evident that the upward shift in real interest rates has significantly contributed to the growth of savings in Sri Lanka. The savings and fixed deposits with commercial banks (quasi money) in 1979 (i.e. after the reform) was more than twice that in 1977. In real terms, these deposits rose at an annual average rate of 33.0 per cent in 1977-80 as against an average of 6.2 per cent in 1970 - 76. Reaching a peak level in 1982, these deposits continued to grow throughout the period upto 1991.

The growth of quasi money, on the other hand, led to a decline in the currency component of money supply. Until 1977 the currency in circulation had accounted for about 33 per cent of M2 and the ratio declined to about 20 per cent by 1981. Partly as a result of the slight downward movement of real interest rates and the civil disturbances in the country since 1983, the share of currency in circulation in relation to bank deposits showed an increase, particularly in 1988. This trend began to reverse in 1989 and could be mainly attributed to the inducement provided to savers through reforms in the financial sector.

10.3 Open Market Operations

In recent years, the Central Bank has made extensive use of open market operations as an instrument of monetary policy. As in the case of many other developing countries, open market operations have proved to be ineffective in Sri Lanka due to factors such as the underdeveloped nature of the money market and

heavy reliance on the banking sector to finance fiscal deficits. Therefore, it was difficult to use open market operations for monetary management purposes until the mid-80's.

In order to expand the role of open market operations, as an instrument of policy, the Central Bank adopted several measures. The main purpose of these measures was to develop the money market so as to reduce heavy dependence of the government on the banking system to finance its budget deficits. It was envisaged that these measures would provide more leverage to the Central Bank to control its domestic assets and thereby influence reserve money. The level of reserve money, in turn, will affect market interest rates. This transmission mechanism was quite different from the earlier methods of monetary control, which involved administered interest rates and directed credit. Such regulations tended to weaken the effectiveness of monetary management and to create distortions in the financial market.

By the early nineteen eighties, it was found that the traditional methods of monetary control had failed to regulate liquidity in the economy and that it would not promote savings and investment under the new open economy arrangements. During the period 1980-83, M2 rose at an average rate of 25 per cent per annum. This was mainly attributable to heavy bank borrowings by the government which had an average budget deficit of 20 per cent of GDP during that period. The liquidity expansion became further acute by 1984 due to an increase in net external assets arising from higher export earnings. Hitherto, the Central Bank had used the conventional instruments like reserve requirements and credit ceilings but these methods of regulation were found to be ineffective to mop up excess liquidity.

Therefore, the Central Bank began to shift the emphasis to open market operations by mid-1984. The money and capital markets were not adequately equipped for open market operations despite the various measures that the Central Bank had taken to develop the market. Meanwhile, the government had to rely heavily on the Central Bank to finance the budget deficit. As public subscription to Treasury Bills were low, the Central Bank had to purchase almost the entirety of the Bill issues and this trend continued until about 1986.

As an initial step to broaden and activate the market, the Central Bank issued its own securities for the first time in 1984.¹ A remarkable feature observed in 1984 was the ability of the Central Bank to contract its net domestic assets and in turn, to control the possible excessive growth of reserve money arising from increasing net

1/ Further issues were made in the two subsequent years and it was phased out in 1989.

PUBLIC LIBRARY
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SPECIAL COLLECTION

foreign assets. (Table 10.3). This was possible mainly through a reduction in credit to government by the Central Bank. The gross credit by the Bank to the government declined by 21 per cent in 1984 and this resulted in a decline of net claims of the government by 24 per cent. This enabled the Central Bank to contract the impact of the net government claims on reserve money by 37 per cent in 1984. The reduction of net government claims was a breakthrough in the context of effective use of open market operations.

Greater public interest in subscription to Treasury Bills was observed in 1984; the Treasury Bill holdings of the non-bank sector rose to 10.3 per cent in 1984 from an average of about less than 1.0 per cent in the previous years. The share of the non-bank sector in Treasury Bill ownership rose rapidly to 39 per cent by 1990. Meanwhile the share of commercial banks also began to increase from 1987 onwards rising from 0.6 per cent in 1986 to 12.7 per cent in 1991. In line with these trends, the Treasury Bill holding of the Central Bank declined sharply from 99.1 per cent in 1983 to 48 per cent in 1991. The growth of the Treasury Bill market is mainly the result of policies adopted by the Central Bank to activate the market. The initial step was the raising of the Treasury Bill rate to 9 per cent in 1977 which had remained unchanged at 5 per cent since 1971. The rate was further increased to 13 per cent in 1980.

The introduction of a secondary market for Treasury Bills in April 1981 was another major factor that led to the development of the Bill market. According to this new scheme, the Central Bank introduced a secondary window for the re-sale of Treasury Bills from its portfolio quoting discount rates between the range of 15.5 to 16 per cent per annum. The market became somewhat active at the initial stages of this scheme due to the lower short term rates that prevailed in the call money market (11-14 per cent). Another development in the Treasury Bill market in 1981 was the introduction of 6 months' bills in addition to 12 months' bills.

In recent years the Central Bank has taken further steps to develop the Treasury Bill market. Since November 1986, the weekly Treasury Bill auction has been in operation and it has become an effective instrument of monetary management. Under the auction system, the public forward their bids to the Central Bank; the bids contain the volume of Treasury Bills demanded and a bid price. The Bank accepts or rejects bids on the basis of a cut-off yield. Since January 1987, the determination of the yield on Treasury Bills has been based on market forces. Since late 1987, the amount of bills to be auctioned has been determined by a committee consisting of Central Bank and Treasury officials. However, the amount of bills offered was largely based on the amount of bills maturing. The cut-off yield has been determined by a Tender Committee. The net domestic assets of the Central Bank has been used as a major intermediate target in determining the cut-off yield since early 1988.

In 1990, Treasury Bills with maturity periods shorter than 3 months were also issued in addition to the issues with maturities of 3, 6 and 12 months. The Central Bank also introduced the Tap System (i.e. outside the auction mechanism) permitting selected commercial banks and money brokers in the Colombo area and its regional offices to participate in sales of Treasury Bills. As a further measure to popularise government securities and to divert black money to the organised money market, Treasury Certificates of Deposits (CDs) were introduced in May 1990. These CDs have been issued with maturity periods of 3, 6 and 12 months at varying discount rates.

The intensified efforts of the Central Bank to sell Treasury Bills to the non-bank sector, both in the primary and secondary markets, helped reduce the net claims on the Central Bank and thereby to reduce the growth of reserve money.

10.4 Refinance Facilities of the Central Bank

The Central Bank has been operating several refinance schemes for specific purposes. These schemes cover guaranteed price schemes, agricultural credit, export credit, temporary liquidity facilities to commercial banks and the Medium and Long Term Credit Fund. Loans and advances granted to commercial banks and other financial institutions by the Central Bank under these schemes affect the money supply through their influence on reserve money. Therefore, the Central Bank has to be cautious to avoid any abrupt effects on reserve money when providing credit to commercial banks and other financial institutions under these schemes.

In some years, credit facilities provided under the schemes caused problems for monetary management. This was particularly evident in 1983, 1986 and 1990 when loans and advances given to financial institutions by the Central Bank increased substantially. The amount of such credit rose by Rs. 1.5 billion in 1983 due to the extension of refinance facilities to the export sector. The amount increased further by Rs. 1.0 billion in 1986 reflecting increased facilities for productive activities. In 1990, refinance granted to the CWE and the Oils and Fats Corporation contributed to an increase of Rs. 3.0 billion. Thus, refinance schemes had an expansionary impact in these three years. For instance, approximately 11 per cent of the reserve money growth in 1990 was caused by refinance facilities.

In 1991, in view of the above adverse consequences, the Central Bank took several steps to rationalise the refinance facilities. These measures included a progressive reduction of refinance facilities for well-established traditional exports, withdrawal of special refinance facilities and review of other finance schemes.

Accordingly, the Central Bank took steps to curtail refinance credit in April 1991; the refinance facilities for bulk tea were to be progressively withdrawn while the coverage of refinance for items under category I was reduced to 50 per cent. As a result of these measures, the total outstanding amount of refinance declined by 17.8 per cent from Rs. 7,330 million at the end of 1990 to Rs.6,029 million in September 1991. This largely reflected the substantial decline in export credit refinance under category I.

It is expected that further rationalization of these schemes will strengthen the ability of the monetary authorities to manage reserve money. As regards lending to commercial banks to overcome their temporary liquidity problems, the Central Bank has imposed limits from time to time on this facility.

10.5 Management of Reserve Money

The Central Bank has used open market operations and management of net claims on financial institutions to control the volume of reserve money in recent years. In other words, the Central Bank controls reserve money by managing its own balance sheet. This section analyses the recent experience of Sri Lanka in using this instrument as a mechanism of monetary control.

The stock of reserve money depends on net foreign assets of the Central Bank, net claims on government and net claims on financial institutions. Now let us examine how the monetary authorities can control the reserve money stock by influencing these components. As regards net foreign assets, the monetary authority in a closed system has greater control since the movements of foreign assets can be more effectively managed by direct import and exchange controls. In a liberalised foreign trade and exchange system the authorities are bound to loose this policy tool as the movement of foreign assets will be largely determined by market forces with minor official intervention.

Considering the above limitations with respect to net foreign assets, the ability of the monetary authority to control reserve money depends to a large extent on the scope available to influence net domestic assets, i.e., net claims on government and financial institutions. It is significant to note here that the Central Bank has made some progress in effecting monetary control through this mechanism as described below.

Until recently the ability of the Central Bank to control its net domestic assets was extremely limited due to heavy borrowings by the government from the Central

Bank. This was largely due to the fact that the money and capital markets in Sri Lanka, owing to its underdeveloped nature, did not provide considerable scope for government borrowings. Following some improvements in the money market and the financial system in recent years, the Central Bank has been able to influence reserve money through net domestic assets to a certain extent.

Net claims on government was a major contributory factor to reserve money growth in 1979-82. These claims declined in 1983 and 1984 reflecting an improved fiscal situation with the export boom.

Table 10.3

Factors Affecting Reserve Money

Year	Net Foreign Assets	Net Claims on Govt.	Net Claims on Finance Institutions	Other Net
1971	12.6	5.9	1.5	7.5
1972	1.7	15.7	-5.1	-6.6
1973	16.9	6.5	6.5	8.2
1974	-12.9	3.0	20.7	6.2
1975	-9.2	9.4	-3.6	1.6
1976	14.2	16.4	-8.7	-3.9
1977	109.2	-9.3	18.4	76.0
1978	49.3	-23.6	5.0	19.7
1979	22.4	25.2	-10.0	13.2
1980	-71.0	122.8	9.0	42.1
1981	-8.8	48.4	4.5	24.8
1982	-12.2	57.4	-0.2	23.5
1983	3.8	7.2	17.0	0.4
1984	60.1	-36.8	-5.4	0.1
1985	-1.2	44.7	-1.3	19.0
1986	-1.4	6.3	6.0	4.1
1987	-3.4	22.5	1.9	14.0
1988	-15.4	43.2	1.9	-3.1
1989	-7.0	4.2	1.8	-5.6
1990	11.2	2.4	11.3	7.0
1991	20.5	12.5	-6.4	4.5

Source: Central Bank of Sri Lanka.

Open market operations helped to contain reserve money growth in 1986 and 1987 despite the continued widening of the domestic financing of the budget deficit. The rate of increase of reserve money fell from an annual average of 21.3 per cent in 1980 -85 to 6.6 per cent in 1986 -87. However, the Central Bank's attempt to control reserve money growth was nullified in 1988 due to a doubling of the domestic financing needs of the government which resulted in a 33 per cent increase in reserve money.

Since 1989 the Central Bank has regulated reserve money effectively through intensified sales of Treasury Bills to the non-bank sector. These measures helped to contain net claims on government and had a favourable impact on reserve money growth. The Central Bank was able to restrict the reserve money growth to 4.8 per cent in 1989 which was 32.6 per cent in the previous year. This was largely an outcome of the decline in the growth of net claims on government in 1989. These claims rose by Rs. 4.0 billion and Rs. 8.3 billion in 1987 and 1988 respectively. The increase was only Rs. 1.1 billion in 1989 and 0.6 billion in 1990. Accordingly, the positive impact of the government sector on reserve money had fallen since 1989. The increase in net claims on government in 1989 as a ratio of the stock of money at the beginning of the year was only 4.2 per cent in 1989 and 2.4 per cent in 1990. In comparison, the ratio was high as 22.5 per cent in 1987 and 43.2 per cent in 1988.

By the end of November 1991, net claims on government rose by Rs. 3.9 billion during the year showing an increase over the previous 2 years. This had resulted from an increase in the budget deficit. As a consequence, the fiscal sector had a larger positive impact on reserve money in 1991, as compared with the two previous years; net claims on government in 1991 as a percentage of reserve money at the beginning of the year was 12.5 per cent. This is smaller than the massive fiscal impact experienced in 1988. It should be emphasised here that the expansionary fiscal impact in 1991 occurred despite the Central Bank's efforts to mobilise financial resources to bridge the fiscal deficit through open market operations. This shows that prudent management of the government budget is essential for effective monetary policy.

10.6 Reserve Requirements

Changes in reserve requirements affect the money multiplier by influencing commercial banks' reserves with the Central Bank. The Central Bank has used this instrument intensively since 1981 (Table 10.4). In order to contain the credit creating capacity of commercial banks so as to reduce their overall liquidity, the reserve ratio on demand deposits was raised from 12 to 14 per cent and the ratio on time and

savings deposits from 5 to 6 per cent with effect from 19th June 1981. This tended to raise the commercial banks' reserves with the Central Bank. These measures were further intensified with effect from 2nd December 1983 by raising the reserve ratio on demand deposits to 16 per cent and the ratio on time and savings deposits to 8 per cent. Unutilised balances of allowed overdrafts were also subject to a reserve ratio of 16 per cent in December 1983.

A new structure of reserve ratios was introduced in 1985. Accordingly, different reserve ratios were specified for each type of deposit varying from 10 to 18 per cent.

Table 10.4

Statutory Reserve Ratios

Effective date	Type of Liability	Revised Rate %
1960.08.26	Demand deposits	12
	Time & savings deposits	05
1981.06.19	Demand deposits	14
	Time & savings deposits	06
1983.12.02	Demand deposits	16
	Time & savings deposits	08
1983.12.16	Unutilized balances of allowed overdrafts	16
1985.08.09	Demand deposits	18
	Time deposits (not exceeding 90 days)	12
	Time deposits (exceeding 90 days)	10
	Savings deposits	10
	Special deposits	10
	Unutilized balances of overdrafts	
1985.09.13	Time deposits (not exceeding 90 days)	14
1987.06.05	Unused balances of overdrafts	0
1987. 08.07	Demand, time & savings deposits	10
1988.02.26	Demand, time & savings deposits	
1988.09.16	Demand, time & savings deposits	15
1991.01.11	Demand, time & savings deposits	13

Source: Central Bank of Sri Lanka

In order to meet the funding needs arising from increased economic activities, particularly in the private sector, it was realised that it would be necessary to allow commercial banks to increase their lending. This relaxation was achieved mainly through a downward revision of reserve requirements and an increase in Central Bank accommodation. Thus, in 1987 the structure of statutory reserve was simplified and a uniform ratio of 10 per cent was introduced on demand, time and savings deposits. Meanwhile, the reserve requirement for unused overdrafts was abolished. The reserve ratio was raised gradually to 15 per cent in 1988 and it was reduced to 13 per cent in 1991.

10.7 Credit Ceilings and Margin Requirements

The Central Bank can impose portfolio constraints on commercial bank through these two direct instruments. As explained in the previous sections, the Central Bank has shifted to market based monetary controls in recent years. However, such controls were inadequate to deal with excess liquidity in the economy in certain periods. In such instances, credit ceilings and margin requirements were used to control bank lending.

In order to arrest domestic credit growth, this type of controls were reintroduced in 1989. Accordingly, commercial bank credit to non-priority sectors were not to exceed the level that prevailed as at end of May 1989. Also, a 100 per cent LC margin requirement for specified imports was imposed in June 1989.

10.8 Supporting Policy Measures

It was necessary to establish certain new procedures with regard to the operating framework of the financial system so as to enable the monetary authorities to function more effectively. Since the administrative controls and other constraints in the financial system were removed, there was a need to strengthen the monitoring of banking and other financial institutions to safeguard their stability. As regards policy formulation, there was also a need to coordinate the main macro variables and for these purposes, certain regulatory rules and coordinating procedures have been introduced in addition to the monetary policy measures.

Among them were rules pertaining to the operations of commercial banks and other financial institutions and these were necessary with the withdrawal of the earlier controls. With the abolition of direct regulation of banks' activities and increasing competition among banks, the banking sector and particularly the State

banks began to face several problems which included non-performing advances, high intermediation costs, debt recovery and credit delivery to the rural sector. ¹

In an effort to deal with these problems, the supervision of commercial banks by the Central Bank has been strengthened under the Banking Act No. 30 of 1978. These include the stipulation of minimum capital funds and liquidity ratios, imposition of limits on lending to a single borrower, placing of limitations on lending to Directors or Directors' interests and imposition of restrictions on shareholdings. Part V of the Banking Act made it mandatory for commercial banks to present their annual statements on the basis of a standard accounting format. In addition, the Central Bank issued a set of guidelines in February 1991 relating to the suspension of interest on non-performing loans and classification of advances for provisioning purposes.

10.9 Policy Directions

In line with the developments in the money and capital markets, the monetary authorities have been able, to a certain extent, to deviate from direct monetary policy measures and to use market based policy instruments. The reformulated monetary policies had significant effects on both the money multiplier and reserve money. The recent reform in the financial sector provided an impetus to the public to increase its savings, mainly in the form of bank deposits. This resulted in a decline in the public's preference to hold cash. Apart from the public's holdings of cash balances, the money multiplier is also affected by commercial banks' reserves against their liabilities. The Central Bank has increasingly used the reserve requirements to regulate this component of the money multiplier.

Sri Lanka has also experienced a break-through in the conduct of reserve money management. Until recently, the monetary authorities were unable to use market based instruments (mainly open market operations) as a monetary policy tool due to deficiencies in the money market. Elimination of direct monetary controls coupled with the recent financial sector reforms have helped to expand the money and capital markets to a certain extent enabling the monetary authorities to use indirect policy measures. For instance, interest rate liberalisation led to raise rates of return for savings. The expansion of the money market through these liberalisation measures has provided an opportunity to the Central Bank to sell and purchase securities, particularly Treasury Bills, to regulate its own balance sheet and, in turn, to influence the overall liquidity of the economy. In an effort to strengthen these monetary controls, the Central Bank has also initiated to phase out the refinance schemes.

1/ These problems were examined by a working committee on the State banks (1989). This type of problems are common to many developing countries. See World Development Report (1989) for a detailed account on this subject.

Although the monetary controls have been shifted gradually towards market-based instruments, certain direct controls are still in operation. These include margin requirements and credit ceilings. As explained earlier, a disadvantage of such types of monetary controls is that they are likely to lead to disallocation of resources.

Another major limitation in the conduct of current monetary policy within a market-based framework is the undue monetary expansion resulting from continuing budget deficits. This is a common problem encountered by many developing countries. This calls for a proper coordination of fiscal and monetary policies, taking into account the periodic trends in key variables such as economic growth, domestic and foreign inflation, balance of payments and savings-investment gap. The experience of Sri Lanka, as in the case of most developing countries, has also revealed that continued adoption of an appropriate fiscal and monetary policy mix in the context of overall macroeconomic policies is essential to materialise any positive effects of economic liberalisation.

In the second half of the 1980's, several finance companies underwent financial difficulties for a variety of reasons. It was felt that this crisis was partly due to the lack of proper supervision. Therefore, a decision was taken to grant more powers to monetary authorities to prevent such failures. The Central Bank has been empowered to regulate non-bank financial institutions under the Finance Companies Act No. 78 of 1988. The Monetary Board is authorised to appoint an officer of the Central Bank as its representative to every finance company for the purpose of monitoring the affairs of a company. In terms of the Finance Companies Act, with effect from 18th December 1988, only public companies registered by the Monetary Board are permitted to conduct finance business. Other finance companies were required to terminate their business within a specified period.

Another significant feature is the attempts that have been made to maintain compatibility between monetary policy and the other macroeconomic policies. For instance, measures have been taken to streamline the economic management process by setting up several committees in 1991; they are the Fiscal and Budgetary Policy Review Committee and Monetary Operations Unit. Similar coordination is evident with reference to balance of payments and exchange rate management.

CHAPTER 11

FINANCIAL SYSTEM

An effective financial system is a key to achieve the basic economic goals in any economy. Financial services facilitate trade of goods and services. The financial system also links savings and investment by providing intermediation services to divest funds from the surplus sectors to the deficit areas. Since investment is a prerequisite to economic growth, the efficiency of the financial system is crucial to growth activities. The diverse financial services are provided to households, businessmen, governments and to foreign bodies. In comparison with the developing countries, the financial systems in the developed economies are more comprehensive and efficient. The high performing East Asian economies also have relatively more efficient financial systems.

The financial system of Sri Lanka consists of an array of institutions. The structure of these institutions has widened and deepened under the market-oriented economic policies. This Chapter examines that institutional structure.

11.1 Institutional Structure

The institutional structure of the financial system of Sri Lanka is given in Table 11.1. The Banking system holds 85 per cent of all financial assets. This is a general feature of developing countries as compared with the industrial countries, in which the banking system holds only about 40 per cent of total assets of the financial system. The share of the Central Bank is 27 per cent in Sri Lanka when compared to an average of 20 per cent in developing countries (emerging markets) and 3 per cent in developed countries. A reason for the Central Bank's higher share in Sri Lanka is the fact that in addition to the currency issues and supervising role, the Central Bank also acts as banker to the Government and other banks and also engages in development financing.

In common with other developing countries, the non-bank financial intermediaries holds a lower share of less than 2 per cent in Sri Lanka than they do in developed countries.

Table 11.1
Sri Lanka: Structure of the Financial system, End of 1993

	Assets Rs. Mn.	Assets %	Assets as % of GDP
Central Bank	133634	30.2	26.9
Commercial Banks	243904	55.1	49.1
Savings & Development Banks	52379	11.8	10.5
Merchant Banks	4108	0.9	0.8
Non-Bank Financial Institutions	9021	2.0	1.8
Total	443046	100.0	89.2

11.2 Monetary Authority

The Central Bank of Sri Lanka functions, as the monetary authority as well as the apex financial institution of the country. The Central Bank was set up under the Monetary Law Act No. 58 of 1949. The primary objective of the Central Bank is to maintain the stability of the currency by protecting its internal and external values. For this purpose, it is essential to curb inflation and to restrain balance of payments deficits. The Central Bank attempts to achieve these goals through its monetary policy instruments as discussed in Chapter 10.

Another major function of the Central Bank is to function as the banker to the bankers. It is universally accepted that the monetary authorities need to act as the lender of last resort when commercial banks face liquidity shortages. Under the Monetary Law Act the Central Bank is empowered to provide credit facilities for this purpose. The Central Bank also has systematic supervision over commercial Banks to ensure macroeconomic stability and to enhance the efficiency of individual institutions.

The Central Bank is the banker to the Government. Accordingly, the Bank functions as the official depository of the Government by maintaining accounts of Government departments, agencies and institutions. The Bank also extends credit facilities to the Government in the form of provisional advances and special loans. Another major function of the Central Bank is to function as the economic advisor to the Government.

Until recently, the administration of exchange control was a major function of the Central Bank. Exchange control was used to contain the foreign exchange

utilisation by imposing restrictions on almost all external transactions. With the gradual removal of these restrictions under the structural reforms (as discussed in Chapters 2 and 3), commercial banks have been authorised to issue foreign exchange more freely.

In addition to the above conventional functions, a major responsibility of the Central Bank is to take appropriate action to improve the efficiency of the financial system so as to promote economic growth. The expansion of the function of the Central Bank has been prominent under the market-oriented economic strategy adopted since the late 1970's. As explained earlier, those reforms were aimed at more efficient resource allocation through trade liberalisation, a flexible pricing and exchange rate system and prudent monetary and fiscal policy measures. In implementing these policies, the Central Bank was expected to play a more dynamic role than ever before particularly to create a financial and monetary system conducive to the working of the private sector. In this regard, the Central Bank has implemented an array of policies in the following areas:

(a) Concessions for Medium and Long Term Capital Formation

The Central Bank has been actively involved in the promotion of investment in productive sectors. A major instrument that has been used for this purpose is the Medium and Long-Term Credit Fund (MLCF). The MLCF was established in July 1964.¹ The need for the Central Bank to engage in promoting credit facilities in such a manner was foreseen in the Exter Report.²

"It is obvious that the resources of the Island cannot be fully developed unless credit is made more freely available. But a Central Bank cannot force a commercial bank to lend when it does not want to lend. It is therefore advisable that in Ceylon the Central Bank should have authority to lend at certain times to credit institutions other than commercial banks and that it should have the authority to take measures to reduce some of the normal risks of lending in Ceylon..... In order to reduce risks of lending in Ceylon the Central Bank should have the authority to act as agent of the Government in such systems of loans insurance or loan guarantees as may be established in the future."

^{1/} The MLCF is governed by Section 88 of the Monetary Law Act introduced by the Finance Act No. 11 of 1963.

^{2/} Report on the Establishment of a Central Bank of Ceylon, Sessional Paper, November 1949, p. 7.

The objective of the MLCF was to encourage lending by credit institutions for productive purposes by making available refinance facilities. The productive purposes were defined to include industry, agriculture, trade, commerce and business as the Monetary Board may determine from time to time. The capital resources of the Fund are based on periodic transfers from the reserves of the Central Bank, capital repayments of loans and interest charges on loans granted. The Central Bank has utilised the resources of the Fund to provide financial accommodation to financial institutions with respect to the advances provided by them for the above-mentioned productive purposes. Accommodation provided by the Central Bank is repayable within a period not exceeding 15 years and should be secured by an assignment to the Bank by way of pledge of debts owed to such institutions and of mortgages given as security to such institutions. At present, refinancing facilities are administered by the Development Finance Department and the Rural Credit Department of the Central Bank.

The Monetary Board has been empowered to prescribe such conditions, as it may deem necessary, subject to which loans and advances will be made available out of the MLCF. The Monetary Board also has the authority to determine the interest rate to be charged by the Central Bank on such loans and advances and the interest rate to be charged by the borrowing institutions. Thus, control of the MLCF has been fully entrusted to the Central Bank. This scheme provided immense support to meet the medium and long term investment needs of the economy. In view of the risk involved and the low rate of return with respect to this type of investment, the traditional banking system is not normally prepared to accommodate such needs. Using the MLCF, the Central Bank has stimulated the financial institutions to grant loans for capital formation in productive activities at concessional terms and conditions while maintaining prudent returns for such loans.

The MLCF became operational effectively only in mid-1966, since there were no loan applicants until then. The annual disbursements in the three years following 1966 remained below Rs.34 million. The Central Bank supported the Tea Factory Modernisation Scheme during that time and agreed to refinance the domestic credit cost of the Project. The foreign exchange cost of the project was to be financed by a loan from the Asian Development Bank. Refinance provided to the project became an important component of the MLCF in subsequent years.

Financial assistance provided under the MLCF began to accelerate in the second half of the 1970s consequent to the expanded investment in hotel projects sponsored mainly by the Development Finance Corporation of Ceylon (DFCC). The willingness of commercial banks to accept the MLCF as a source of investment also helped to extend the scheme.

In order to meet growing financial needs, the Central Bank undertook a major revision of the MLCF in the latter half of 1979. This revision was expected to direct resources into priority sectors in the economy. This was achieved by means of changes in the amount of refinance, rate of refinance and other terms and conditions. Taking into account the export-oriented growth strategy introduced after 1977, the Central Bank expanded the scope of the MLCF further in 1980 so as to enable commercial banks and credit institutions to participate more comprehensively in the promotion of export-oriented industries designated by the Export Development Board qualified for concessional finance from commercial banks and credit institutions. Loans granted under the scheme are eligible to receive upto 80 per cent refinance from the MLCF at a refinance rate of 10 per cent.

Following the revision, the projects that qualify for assistance under the MLCF have been divided into four categories.

Category I : Loans given for agriculture and fisheries under scheme approved by the Ministries;

Category II : loans granted for promotion or development of exports from Sri Lanka, including production of goods and commodities for export and activities antecedent to such production like cultivation of agricultural products and setting up of facilities for procuring and manufacturing for export of agricultural and industrial goods;

Category III : loans given for approved investments carrying tax holidays (under Section 17 of the Inland Revenue Act No. 28 of 1979) and loans given for agriculture and fisheries outside the schemes approved by the Ministries; and

Category IV : loans granted for purposes other than those spelt out above, which the Monetary Board may consider at its discretion as coming within the meaning of "productive purposes" as defined in Section 88 of the MLA.

The amount of loans refinanced has increased considerably following the reforms of the MLCF. The refinanced amount of loans increased from Rs.122 million in 1980 to Rs. 441 million in 1989 as shown in Table 11.2. It is also significant that increased assistance has been given to sick industries under the MLCF in recent years.

The Central Bank introduced a package of relief measures to the tourist industry which was hampered by civil disturbances. This scheme provided a moratorium on the repayments of principal and interest on loans upto March, 1987, to be followed by a rescheduling of outstanding debt over an extended period and refinancing of

60 per cent of the interest arrears by the Central Bank. Following the continued setback in the tourist industry, the moratorium was extended to March 1989 with a further concession of 100 per cent rescheduling of loans.

The role played by the Central Bank in the provision of credit facilities to the rural sector is also noteworthy. The Bank introduced a series of rural credit schemes over the past three decades, e.g. the New Agricultural Credit Scheme (1967), the New Agricultural Credit Scheme (1973) and the New Comprehensive Rural Credit Scheme (1986). All these schemes were aimed at delivering credit to the rural sector at reduced costs. The Central Bank also played the role of the credit executing agency for the rural based projects funded by foreign agencies such as the Asian Development Bank and International Fund for Agricultural Development. The Inland Bill Scheme introduced by the Central Bank in 1989 eased the working capital requirements of the tea processing industry. These functions are handled by the Rural Credit Department of the Bank.

Table 11.2
Medium and Long Term Credit Fund
Approvals of Refinance Under Categories II, III and IV
(Rs.Mn.)

	1980		1983		1986		1989	
	LA	RA	LA	RA	LA	RA	LA	RA
Category II								
Export Sector	-	-	43.7	36.5	41.4	29.0	46.2	32.2
Category III and IV								
(a) Agriculture	1.0	0.7	27.8	19.2	134.4	80.6	14.7	8.8
(b) Industry	62.1	49.0	9.7	7.0	1.0	0.6	38.4	21.2
(c) Hotels	52.0	36.0	13.2	8.6	2.5	1.5	-	-
(d) Other	60.0	36.0	5.8	3.5	6.5	14.7	80.0	80.0
Assistance to								
Sick Industries	-	-	-	-	325.4	316.4	463.1	298.2
Total	175.1	121.7	100.2	74.8	521.4	442.8	639.4	440.5

Source : Central Bank of Sri Lanka

Note : LA = Total amount of loans;
RA = Refinanced amount of loans.

As a further measure to promote domestic investment, the Central Bank has been involved in the issue, service and repayment of government guaranteed debentures on behalf of several organisations including the National Housing Department, the State Mortgage and Investment Bank, the Development Finance Corporation and the Urban Development Authority. The Bank began this function in 1954. These activities are administered by the Public Debt Department of the Bank.

(b) Credit Guarantee Schemes

A major problem faced by small and medium scale entrepreneurs in obtaining credit facilities from the banking system in Sri Lanka, as in many other developing countries, is the lack of acceptable securities against which loans would be granted. From the viewpoint of solvency, commercial bankers generally require valuable securities against the loans they grant. As anticipated in the Exter Report, the Central Bank has to intervene in the credit supply process by introducing a Credit Guarantee Scheme.

The Central Bank commenced issuing credit guarantee under the Small Scale Industries (SSI) Scheme in April 1978, in collaboration with the Industrial Development Board. It covered loans granted to small industrialists by the People's Bank, the Bank of Ceylon and the Development Finance Corporation. The Central Bank guaranteed 75 per cent of the original sum granted or amount in default, ever which was less. The issue of guarantees under the SSI was completed in 1981. A total of 767 loans amounting to Rs.31.2 million was covered under the SSI Scheme. Of this, the Central bank guaranteed a sum of Rs.23.4 million.

The Small and Medium Scale Industries (SMI) Scheme came into operation in July 1979 under an agreement signed by the Government with the International Development Association (IDA). A sum of US Dollars 12 million was made available to the National Development Bank (NDB) to refinance SMI projects and a further sum of US Dollars 4 million was given to the Industrial Development Board to meet the costs of technical assistance with respect to these projects. The SMI Project loans were to be refinanced by the IDA and administered by the ADB.

Since 1979, the following SMI schemes have been in operation:

SMI I Scheme

PUBLIC LIBRARY
JAFFNA

This Scheme commenced operations in 1979 and was completed in 1982. A total of 1,668 loans amounting to Rs.286 million was made available under this Scheme. The total amount of loans guaranteed was Rs.158 million.

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SMI II Scheme

The issue of credit guarantees under this Scheme commenced in 1982 and was completed in 1989. The total number of loans provided under the Scheme was 2,531 for a sum of Rs.1,392 million. Of this amount, Rs.714 million was guaranteed.

SMI III Scheme

The third SMI Scheme became effective in July 1988. As at end of 1989, a total of 1,047 loans amounting to Rs.636 million had been issued under the Scheme. Of this, Rs.440 million was guaranteed.

A summary of the performance of SMI II and III during 1982 - 89 is given in Table 11.3.

Table 11.3
SMI II and III Schemes, 1982 - 89
Industry-wise Classification

Industry	No. of Loans	Amount of Loans Rs. Mn.	(Rs. Mn.)
			Guaranteed Amount Rs. Mn.
1. Food Processing	1,052	604.2	327.2
2. Other Agro Industries	73	31.5	17.9
3. Rubber Products	115	98.2	54.7
4. Metal Products	334	163.1	90.6
5. Construction Materials	262	140.3	87.6
6. Construction Contracting	40	40.3	22.3
7. Wood Products	241	94.1	59.4
8. Garments	206	124.1	71.3
9. Textiles	78	63.2	35.3
10. Repair Workshop	147	56.7	35.2
11. Miscellaneous	1,030	616.7	353.3
Total	3,578	2,032.6	1,154.7

Source: Central Bank of Sri Lanka.

The Central Bank also provides short term working capital to exporters by means of two refinance schemes, i.e. the Pre-shipment Export Credit Refinance Facility and the Supplementary Refinance Facility. Under the Pre-shipment Export Credit Refinance Facility, the Central Bank has supplied concessionary financing through commercial banks to the exporters of tea, rubber, coconut, gems, garments and sea-food products. Refinancing is provided for a period of 60 days extending to 90 days on a case by case basis. The interest rebate paid by the Central Bank to exporters is 4 per cent per annum. The objective of the Supplementary Financing facility is to promote non-traditional exports and to induce commercial banks to deliver pre-shipment financing to small scale exporters. This facility can be utilised by exports of products not accommodated under the Pre-shipment Export Credit Refinance Facility. Refinance is granted to exporters for a period of 90 days by way of discounting promissory notes tendered to commercial banks. The interest component borne by the Central Bank is 4 per cent.

(c) Protective Measures for Financial Institutions

The stability of financial institutions is a pre-requisite to promoting both savings and investment. In the latter part of the 1980's several non-bank financial institutions in the private sector underwent severe liquidity problems and as a result, some of them collapsed. This was partly due to the mismanagement of such companies. By the end of the 1980's commercial banks began to be disturbed by financial pressures emerging from bad and doubtful debts, mainly on account of wilful defaulters.¹ These tendencies were harmful to the growing savings and investment activities of the economy and therefore, the Central Bank took timely action to overcome difficulties so as to restore the stability of financial institutions.

In order to regulate and supervise finance companies, the Central Bank established a new department in 1988, i.e. the Department for Supervision of Non-Bank Financial Institutions.^{2/} Under the new Law, the Central Bank was vested with more powers to control these companies. Accordingly, the Monetary Board was permitted to impose penalties on errant finance companies.

^{1/} Bad and doubtful debts have caused considerable financial distress for many financial institutions in developed and developing countries. For an analysis of such failures, see World Development Report, World Bank, 1989.

^{2/} Finance Companies Act No.78 of 1988.

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Substantial rates of default emerged as a major threat to commercial banks and other financial institutions in the late eighties. This problem was more acute in the two state owned commercial banks. In view of these considerations, the Minister of Finance appointed a Committee in August, 1989 with the Governor of the Central Bank as Chairman, to report on non-performing advances and other current problems, including rising intermediation costs and credit delivery. In its Report ^{1/} the Committee highlighted the gravity of the debt recovery problem and recommended several measures to expedite the procedures. The Committee presented a plan of action aimed at proper debt recovery, low intermediation costs and efficient credit delivery.

A significant contribution of the Central Bank towards developing a climate conducive to investment is the initiative taken by the Bank to adopt new legislation to regulate debt recovery procedures. Accordingly, 13 Acts (including amendments to certain existing Acts) were passed in Parliament in March 1990. Shortcomings of the existing legislation were largely responsible for the prolongation of debt recovery. The new Law ^{2/} provided for special recovery procedures with respect to lendings of licensed commercial banks, development banks and finance companies. Under the new regulations,^{3/} the parate execution powers hitherto enjoyed by the state banks have been extended to all commercial banks and the DFCC. As part of the policy package of credit recovery, the Credit Information Bureau ^{4/} was set up in June 1990 to centralise the data on loan defaulters.

11.3 Commercial Banking

Commercial banks play a central role in the economy by way of mobilising financial resources and delivering credit to various activities in different sectors. Commercial banks accept money from the public for non-interest bearing current accounts and interest bearing savings and fixed deposits. Customers have the right to withdraw on demand the monies in their current accounts. Commercial banks deliver loans and advances. They also facilitate foreign trade by providing finance to exports and imports and processing trade documentation.

^{1/} Report of the Committee on the Two State Banks, February 1990 (unpublished).

^{2/} Debt Recovery (Special Provisions) Act No. 2 of 1990.

^{3/} Recovery of Loans (Special Provision) Act No. 4 of 1990.

^{4/} Credit Information Bureau of Sri Lanka Act No.18 of 1990.

Commercial banking in Sri Lanka has a long history dating back to the early part of the 19th century. During that period, financing of commerce and trade was done by 'Chettiers', who functioned as individual money lending organisations. These services were inadequate to meet the financial requirements of the growing foreign trade activities and therefore a need to establish commercial bank was felt. The first commercial bank known as the Bank of Kandy was established in Kandy in 1828, under the British rule. It operated until 1930. Thereafter, the Bank of Ceylon (not the present one) was set up in 1841. It was affected by adverse price trends in coffee in the middle of the century and was taken over by the Oriental Bank in 1851.

In the second half of the 19th century, 10 branches of foreign banks were established in Sri Lanka making the beginning of commercial banks. As the banks failed to meet the credit needs of the domestic economy, the Banking Commission was appointed in 1934 to examine the existing banking and credit conditions of the country. Following the recommendations of the Commission, the Bank of Ceylon was established in 1939.

During the period 1960-1977, action was taken to restrict the activities of foreign banks and to strengthen State banks. Accordingly, in 1961 the Bank of Ceylon was nationalised. In the same year the People's Bank was set up as another State Bank. Measures were taken to discourage Sri Lankans to open accounts in foreign banks. As a result, the share of domestic banks in total deposits rose from 60 per cent in 1960 to 90 per cent by 1976.

The economic reforms adopted since 1977 have been instrumental in transforming the commercial banking system into a dynamic one that could meet the requirements of a market-oriented economy. As explained in Chapters 2 and 3, these policies were aimed at liberalising the financial sector and improving efficiency through competition. Accordingly, the restrictions placed on the operations and establishment of branches of foreign commercial banks were removed and interest rates were liberalised. The liberalisation of commercial banking has led not only to an expansion of the banking services but also to an improvement in the efficiency of banks. The liberalisation also helped to restrain the oligopolistic position of State banks reducing their share of bank deposits from 90 per cent in 1976 to 66 per cent by 1991.

The bank networks expanded from 263 branches in 1975 to 932 in 1993. As a result, the population per branch declined from 51,316 in 1975 to 18,905 by 1993.

Conversely the Banking Density Index ^{1/} which the number of banks branches per 10,000 people increased from 0.19 in 1975 to 0.53 in 1993.

Table 11.4
Expansion of Commercial Banks

Year	No. of Branches	Population per Branch	Banking Index
1970	165	75,855	0.1318
1975	263	51,316	0.1949
1980	489	30,157	0.3316
1985	600	26,395	0.3789
1986	604	26,684	0.3748
1987	608	26,910	0.3712
1988	693	23,934	0.4200
1989	717	23,439	0.4300
1990	765	22,213	0.4500
1991	809	21,319	0.4700
1992	885	19,667	0.5100
1993	932	18,905	0.5300

Source: Calculated from Central Bank Annual Reports.

Commercial banks performed well in mobilising deposits (Table 11.5). The Banks accept 3 types of deposits namely, current, time and savings deposits. The total amount of deposits as a ratio of GDP increased from 15 per cent in 1977 to 22 per cent in 1985. Another significant development is the increase in the share of time deposits in line with the corresponding decline in the relative importance of demand deposits. A factor that contributed to this trend is the upward movement of real interest rates for time and savings deposits following the interest rates liberalisation. About one half of the total deposits was generated by individuals. Trading, manufacturing and other business account for about one fourth of total deposits.

$$^{1/} \text{ Banking Density Index} = \frac{\text{No. of Branches}}{\text{Population}} \times 10,000$$

Table 11.5
Deposits with Commercial Banks

(Rs. Million)

	1 9 7 7				1 9 8 5			
	Demand	Time	Savings	Total	Demand	Time	Savings	Total
1. Financial Institutions	118	203	31	353	404	2636	66	3106
2. Plantations	226	185	4	416	642	610	13	1262
3. Trading	514	196	42	752	1079	1291	78	2448
4. Manufacturing Business	218	59	4	281	776	908	24	1708
5. Other Business	385	111	17	514	1552	2164	1354	5070
6. Non-Business Institutions	205	115	23	342	994	2480	67	2541
7. Local Govt. Bodies	47	25	1	73	180	337	8	524
8. Individuals	640	567	1369	2576	2647	8582	7634	18863
9. Total	2354	1461	1491	5306	8274	19005	9245	36523
Share (%) in Total - Deposits	44	28	28	100	23	52	25	100
As % of GDP	7	4	4	15	5	12	6	22

Source: Central Bank of Sri Lanka.

Commercial banks have expanded their credit delivery to meet the financial requirements of the liberalised economy. The total amount of loans and advances as a ratio of GDP increased from 16.4 per cent in 1977 to 23.5 in 1985 and to 24.9 per cent in 1993. Of the total amount of credit, nearly one half was disbursed to commercial activities. The share of the industrial sector in total loans declined from 21.5 per cent in 1977 to 13.9 per cent in 1994. A reason for this may be the increased foreign participation in industrial ventures in recent years due to relaxation of restrictions of foreign investments. Other significant features observed for the period 1977-93 are a gradual decline in the share of the agricultural sector and the increased proportion for housing activities.

FCBUs accept foreign exchange for demand, time and savings deposits. In addition, to disbursement of loans in foreign currency, they facilitate functions such as establishing letters of credit, issuing and re-issuing of guarantees and discounts of bills and acceptances.

Apart from the conventional types of deposits, commercial banks are permitted to offer Non-resident Foreign Currency Accounts (NRFC), Resident Foreign Currency Accounts (RFC) and Numbered Accounts.

The financial sector reforms have helped commercial banks to engage more freely in money and capital markets and foreign exchange operations. The Inter-bank call market has become activated after 1977. The call market rates are determined by the demand and supply conditions. In the case of Treasury Bills, the banks have increasingly participated in the secondary market and repurchase transactions. Inter-bank foreign exchange transactions also have increased after the reforms. It is significant to note that a close link among the call market, secondary Treasury bill market, repurchase transactions and foreign exchange operations have evolved over the years.

Commercial banks have assumed a wider role following the deregulation and reform of the banking system. A major development in this context was the introduction of off-shore banking in Sri Lanka by allowing all commercial banks to establish Foreign Currency Banking Units (FCBUs) separately from their domestic business. The purpose of this measure was to facilitate foreign investments and to develop Colombo as an international financial centre. A FCBU is defined as a separate unit of commercial banks established specifically for accepting foreign currency deposits and granting loans in foreign currency. BOI enterprises and other residents approved by the Central Bank are eligible to do business with FCBUs.

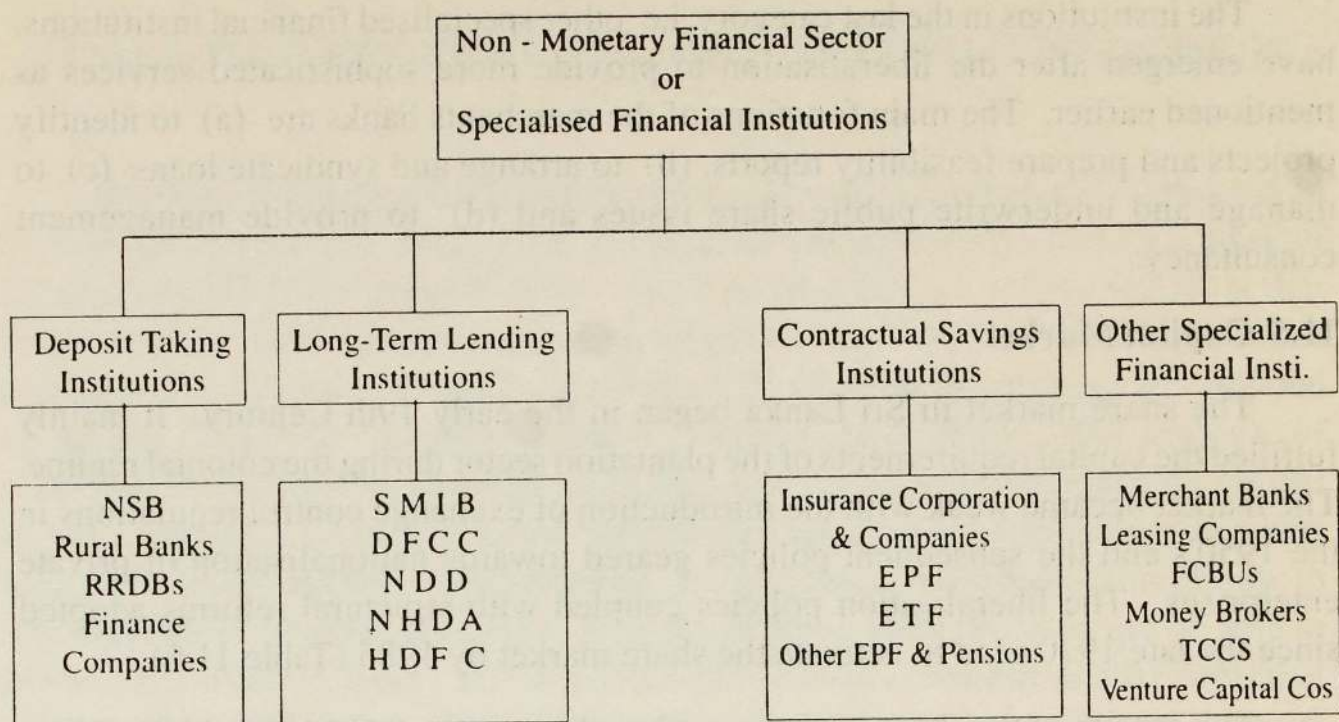
11.4 Specialised Financial Institutions

In addition to commercial banks, several other financial institutions are in operation in Sri Lanka. Some of these institutions were established long ago to perform specific functions such as mobilisation of small savings, provision of credit to productive activities and protection of employees after their retirement. However, the expanding economic activities led by the liberalisation demanded more sophisticated institutions which could deal with functions like project evaluation, management consultancy, co-financing and syndication of loans. The post-liberalisation period saw the growth of such institutions.

Since the activities of the specialized financial institutions do not affect the money supply directly, they can be considered as non-monetary financial institutions. This sector consists of 4 types of institutions (Chart 11.1), namely (1) Deposit taking institutions, (2) Long-term lending institutions, (3) Contractual savings institutions and (4) Other specialised financial institutions.

From among the deposit taking institutions, the National Savings Bank (NSB) is the largest one. The NSB was set up in 1972 in order to mobilise savings, particularly from small savers and to promote savings in the areas where banking facilities are lacking.

Chart 11.1
Structure of Non-Monetary Financial Sector



The Rural Banks (RBs) were introduced in 1964 by the People's Bank to cater the rural sector by mobilising savings and facilitating credit delivery.

Another major institutional arrangement is the Regional Rural Development Banks (RRDBs) established in 1985.¹ This innovative scheme reflected the commitment of the Central Bank to participate directly in the mobilisation of rural savings and the diversion of such savings to priority sectors. It was expected that RRDBs would supplement the activities of commercial banks with respect to rural credit and thereby would help promote investment in rural areas. Unlike in conventional commercial banking, where considerable importance is attached to securities in the disbursement of loans, RRDBs were to base their loan assessments on the viability of each project. The RRDBs are found to be successful in savings mobilisation and credit delivery with respect to small entrepreneurs in the rural sector, mainly due to the positive attitude of the officers toward providing credit to the rural poor for production purposes. It appears that these banks have helped to realise the concept of 'bare foot' banking in rural areas.

The finance companies mainly provide hire purchase financing.

In the category of long term lending, several institutions provide medium and long term credit facilities.

^{1/} Regional Rural Development Bank Act No.15 of 1985.

The contractual savings institutions are geared to collect regular premiums from the employees and to provide them with financial benefits after their retirement.

The institutions in the last category, i.e. other specialised financial institutions, have emerged after the liberalisation to provide more sophisticated services as mentioned earlier. The main functions of the merchants banks are (a) to identify projects and prepare feasibility reports, (b) to arrange and syndicate loans (c) to manage and underwrite public share issues and (d) to provide management consultancy.

11.5 Capital Market

The share market in Sri Lanka began in the early 19th Century. It mainly fulfilled the capital requirements of the plantation sector during the colonial regime. The market became weak with the introduction of exchange control regulations in the 1950's and the subsequent policies geared towards nationalisation of private enterprises. The liberalisation policies coupled with structural reforms adopted since the late 1970's led to activate the share market by 1985 (Table 11.6).

The growth of the share market was slow during the period 1985 -1989. Since 1990, it showed rapid development mainly due to the financial sector reforms and liberalisation of foreign investments.

The activities of the share market were supported by a scheme of Unit Trusts. These are established under the Securities and Exchange Commission Act. A Unit Trust collects funds from the public selling its units and these funds are utilised to buy shares of listed companies. Therefore, these trusts help to activate the share market by providing financial resources through their funds.

Table 11.6
Sri Lanka's New Share Issues in the Primary Market

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Total No. of Share Issues	05	13	19	37	13	03	05	05	10	02	01	05	13
No. of Shares Offered (Mn)	1.39	28.43	37.11	94	63.25	8.74	101.75	20.59	20.1	14	7.0	12.1	83.1
Value of Shares Offered (Rs. Mn.)	13.9	284.7	311.1	1004.2	632.5	87.4	130.5	205.9	201.4	140	70.0	121.5	1296.2
Share Investment as a percent of Total Financial Savings	0.2	4.3	2.8	8	5	0.8	1.6	1.4	1.1	0.9	0.8	0.5	2.0

Source: Central Bank of Sri Lanka

CHAPTER 12

FINANCIAL DEEPENING AND ECONOMIC PROGRESS

The issue of financial deepening has been increasingly taken into consideration in economic reforms of developing countries following the path breaking work of Mckinnon (1973) and Shaw (1973). The central argument of this school is that financial repression reduced "the real rate of growth and the real size of the financial system relative to non-financial magnitudes." In all cases this strategy has stopped or gravely restricted the development process (Shaw, 1973). The removal of financial repression through financial liberalisation policies would make the returns on the assets with official financial institutions (mainly time and savings deposits with commercial banks) more attractive, and therefore, more funds would flow to this segment of the capital market. As a result, these institutions would be able to reduce their credit rationing and would disburse cheaper credit to smaller firms that had been neglected earlier. With the expansion of credit provided by official financial institutions, the curb market would be phased out gradually. It is expected that this would lead to an improvement in the overall efficiency of resource allocation since the distribution of credit in the organised sector will be based on the rates of returns rather than on administrative rules. Thus, it is expected that financial liberalisation will lead to a process of financial deepening thereby accelerating economic growth.

The purpose of this Chapter is to examine whether the current financial reforms adopted in Sri Lanka had led to financial deepening and in turn, accelerated economic growth.

12.1 Experience of Financial Deepening in Sri Lanka

The characteristics of capital market segmentation leading to financial repression as pointed out by Mckinnon (1973) and Shaw (1973) were evident in Sri Lanka until the adoption of the financial sector reform packages. In the pre-reform period the money and capital markets had been fragmented with an official segment consisting of formal financial institutions (mainly banks) and an unregulated market segment consisting of informal credit institutions and private money lenders. Interest rates remained high in the informal market. In contrast, in the official segment interest rates were kept at low levels by means of interest rate ceilings, subsidised credit allocations and high reserve ratios. Meanwhile, the banks found it difficult to attract deposits due to low interest rates. Therefore, they had to ration their

credit, giving priority to large scale established enterprises. Since the small scale borrowers were neglected by official institutions in that system they depended on the informal segment ("curb" market) at high cost. As explained in Chapter 10, the new monetary control framework helped to overcome some of these problems.

12.2 Financial Development Models

Following the introduction of the concept of financial deepening by Mckinnon (1973) and Shaw (1973), several theoretical models have been developed to assert that economic growth can be raised by eliminating "repression" in the financial sector, that resulted from administrative measures such as interest rate ceilings, reserve requirements tax and selective credit controls. The central argument of Mckinnon and Shaw is that financial repression reduces the real rate of growth and the real size of the financial system relative to non-financial magnitude. In all cases this strategy has stopped or gravely retarded the development process (Shaw 1973). It is argued that financial repression in developing countries is largely covered by interest rate ceilings leading to negative real interest rates, i.e. the inflation rate exceeds the administratively controlled nominal interest rates. Low real interest rates discourage savings and thus, act as a major constraint to growth. Therefore, a the policy prescription suggested by Mckinnon and Shaw for financial repression is to raise institutional interest rates or to reduce inflation. It was argued that abolishing interest rate ceilings will not only raise investment but also will raise the average efficiency of investments.

In this section, a simple model of financial development is estimated for Sri Lanka using the data for 1977-91. The hypothesis to be tested is that the upward movement of real interest rates will raise real financial savings and thereby promote investment and economic growth. In the absence of accurate data of financial savings, we use real balances of broad money (M2/P) as an indicator of financial assets. (where M 2 = broad money and P = consumer Price Index.)

It is assumed that the rate of economic growth (Y/P) is a function of the rate of change of real financial assets as follows:

$$(Y/P) = A_0 + a_1 (M2/P) \quad (i)$$

Real financial assets are assumed to be dependent on real interest rates, i.e. difference between nominal interest rates (i) and domestic inflation (p).

$$(M2/P) = b_0 + b_1 (i - p) \quad (ii)$$

Using the time series dates for the period 1977 to 1991, the following Ordinary Least Square functions were estimated:

$$(Y/P) = 4.0176985 + 0.23986 (M2/P) \quad (1)$$

R²

R = 0.397; DW=1.39

$$(M2/P) = 4.5433590 + 1.1372757 (i - p) \quad (2)$$

R²

R = 0.314; DW = 0.77

The following equation is in log-linear form :

$$\text{Log } (Y/P) = 8.1735686 + 0.7784568 \log (M2/P) \quad (3)$$

R²

R = 0.936; DW = 0.89

The above equations imply that there is a close statistical relationship between economic growth and real financial assets, on the one hand and real interest rates and real financial assets, on the other. This is evident from the fact that in all equations dependent variables are significant at the 1 per cent level. In this model, an increase in real interest rates will enhance real financial assets and thereby promote economic growth. It may be noted here that the elasticity of real GDP with respect to real financial assets is 0.77.

In the case of Eq. (1), the base path follows the actuals satisfactorily except for the low growth years, between 1987 and 1989. The simulated growth rates of real financial assets based on Eq. (2) seem to predict the fluctuations correctly, but the base path lies above the actuals throughout the period 1981 - 89. These drawbacks may be largely due to the narrowness of the present specification. The estimates are based on single variable equations and therefore, they do not capture the complex relationship that exist in the real sector and financial markets. Nevertheless, the estimates are helpful to ascertain the impact of financial deepening on economic growth in Sri Lanka.

... 1987 to 1991, the following ...

R = 0.97
R = 0.97

The following ...

... 1987 to 1991, the following ...

... 1987 to 1991, the following ...

CHAPTER 13

GOVERNMENT FISCAL OPERATIONS

Fiscal strategy in the post-1977 period was aimed at shifting budgetary resources from consumption to investment. Accordingly, action was taken to remove subsidies, particularly on food items. Current expenditure was further reduced subsequently by curtailing transfer payments to state-owned enterprises through a comprehensive privatization programme. Such action was required under the economic reforms, in which a major element was to allow the private sector to do its economic activities without intervention by the Government. Also, the public sector was expected to facilitate private sector activities merely by providing the necessary infrastructure facilities. This required larger magnitudes of capital expenditure.

On the revenue side, more resources were to be mobilised to meet the increasing expenditure. At the same time, there was a need to provide fiscal incentives so as to induce private sector investments. For these purposes, the Government embarked on a major review of the tax system in the late 1970s. It was envisaged to adopt a tax structure more responsive to income growth and less vulnerable to fluctuations in international commodity markets. The tariff structure was also revised after the liberalisation taking into account factors such as export competitiveness and flow of imports.

Macroeconomic stability is a prerequisite to sustain the open economy as well as to maintain the growth momentum. In this regard, fiscal operations are crucial. Excessive budgets generally lead to monetary expansion and thereby to worsen the external payments situation and to accelerate inflation. As explained in the following sections, continuous budget deficits in Sri Lanka have been largely responsible for the macroeconomic instability.

13.1 Government Revenue

The Government revenue consists of both current and capital receipts. The current revenue accounts for about 97 per cent of the total (Table 13.1).

The major source of current revenue is taxes on production, expenditure and income which together contributed about 85 per cent of the total revenue (Table 13.2). Other current revenue items are interest and dividends and receipts from

trading enterprises. The share of taxes on production and expenditure increased in 1993 as compared with 1977. In the meantime, the share of income taxes and gross receipts of trading enterprises declined between 1977 and 1993. This was partly a result of the increased income tax concessions granted to the productive enterprises.

The single most important item of purchases is the general sales and turnover taxes which contributed Rs.29.4 billion equivalent to one third of total tax revenue in 1993. This source contributed only about 13 per cent up to the early 1980's. The increase in these taxes since then was mainly due to the imposition of turnover taxes on imports in 1981, which had hitherto been restricted to domestic manufacturing and service activities.

Selective sales taxes contribute about one fifth of the total tax revenue. This category includes excise taxes and defence levy. Excise taxes are levied on tobacco, cigarettes, liquor and selected luxury goods. The revenue from selective sales taxes in 1993 was equivalent to 3.3 per cent of GDP.

Taxes on foreign trade contributes about one fourth of total revenue which was equivalent to about 5 per cent of GDP in 1993. Almost the entire amount of these taxes was on import duties. Dependence on foreign trade taxes has declined considerably during the post-1977 period due to the gradual elimination of export taxes under the export oriented growth strategy. Export taxes which generated nearly one third of the total revenue in 1980 declined to a negligible level by 1993. This was partly offset by a gradual increase in import duties in line with import liberalisation. The increase in import duties was significant after 1984.

The change in the import tariffs were guided by the recommendations of the Presidential Tariff Commission which was appointed in 1980. The purpose of this Commission was to provide a continuous review of import tariffs and to make recommendations on an appropriate tariff structure. Based on the recommendations of the Commission, a more rational structure of import tariffs was introduced in 1984. These recommendations were aimed at providing incentives to production and adequate protection to local industry. Accordingly, import duties on certain categories of intermediate goods (mainly fertilizer, cement clinker and chemicals) were removed completely while duties on other categories of investment and intermediate goods (machinery, motor vehicles, iron, steel, etc.) were reduced substantially. Duties on consumer goods such as medicines, infant milk foods and printed books were also removed. Higher duties were imposed on products (full cream milk powder, rice, sugar, sanitaryware, etc.) which were competitive with local industry.

Table 13.1
Government Revenue

	1977	1980	1985	1990	1993
1 Current	6,545	13,912	38,632	69,937	100,756
1.1 Taxes on Income	937	2,086	5,586	7,336	13,658
1.1.1 Personal		378	1,424	2,957	5,272
1.1.2 Corporate		1,708	4,162	4,379	8,386
1.2 Taxes on Production & Expenditure	4,504	10,372	25,048	54,411	74,402
1.2.1 General Sales & TT	711	1,640	10,189	20,291	29,382
1.2.2 Selective Sales Taxes	1,407	1,878	4,014	9,481	18,976
1.2.3 Import Duties	518	2,925	8,396	17,512	21,401
1.2.4 Export Duties	620	3,638	1,873	1,238	57
1.2.5 Licence Taxes	54	82	188	310	59
1.2.6 Property Transfer Fees	37	209	388	2,960	3,454
1.2.7 Taxes on Treasury Bills (cb)	0	0	0	2,619	1,073
	1,157				
1.3 Interest & Dividends	371	251	2,664	1,353	6,800
1.4 Gross Receipts of Trading Enterprises	514	836	2,151	3,893	1,536
1.5 Other	219	367	3,183	2,944	4,360
2. Capital	143	157	379	914	3,702
Total	6,688	14,069	39,011	70,851	104,458

Government Revenue %

1. Current	97.9	98.9	99.0	98.7	96.5
1.1 Taxes on Income	14.0	14.8	14.3	10.4	13.1
1.1.1 Personal	n.a.	2.7	3.7	4.2	5.0
1.1.2 Corporate	n.a.	12.1	10.7	6.2	8.0
1.2 Taxes on Production & Expenditure	67.3	73.7	64.2	76.8	71.2
1.2.1 General Sales & TT	10.6	11.7	26.1	28.6	28.1
1.2.2 Selective Sales Taxes	21.0	13.3	10.3	13.4	18.2
1.2.3 Import Duties	7.7	20.8	21.5	24.7	20.5
1.2.4 Export Duties	9.3	25.9	4.8	1.7	0.1
1.2.5 Licence Taxes	0.8	0.6	0.5	0.4	0.1
1.2.6 Property Transfer Fees	0.6	1.5	1.0	4.2	3.3
1.2.7 Other Taxes	17.3	0.0	0.0	3.7	1.0
1.3 Interest & Dividends	5.5	1.8	6.8	1.9	6.5
1.4 Gross Receipts of Trading Enterprises	7.7	5.9	5.5	5.5	1.5
1.5 Other	3.3	2.6	8.2	4.2	4.2
2. Capital	2.1	1.1	1.0	1.3	3.5
Total	100.0	100.0	100.0	100.0	100.0

Source: Central Bank of Sri Lanka

PUBLIC LIBRARY
JAFF
SPECIAL COLLECTION

Table 13.2
Tax Revenue

	Rs. Mn.				
	1977	1980	1985	1990	1993
1.1 Taxes on Income	937	2,086	5,586	7,336	13,658
1.1.1 Personal		378	1,424	2,957	5,272
1.1.2 Corporate		1,708	4,162	4,379	8,386
1.2 Taxes on Production & Expenditure	4,504	10,372	25,048	54,411	74,402
1.2.1 General Sales & TT	711	1,640	10,189	20,291	29,382
1.2.2 Selective Sales Taxes	1,407	1,878	4,014	9,481	18,976
1.2.3 Import Duties	518	2,925	8,396	17,512	21,401
1.2.4 Export Duties	620	3,638	1,873	1,238	57
1.2.5 Licence Taxes	54	82	188	310	59
1.2.6 Property Transfer Fees	37	209	388	2,960	3,454
1.2.7 Other Taxes	1,157	0	0	2,619	1,073
Total	5,441	12,458	30,634	61,747	88,060
Tax Revenue %					
1.1 Taxes on Income	17.2	16.7	18.2	11.9	15.5
1.1.1 Personal	0.0	3.0	4.6	4.8	6.0
1.1.2 Corporate	0.0	13.7	13.6	7.1	9.5
1.2 Taxes on Production & Expenditure	82.8	83.3	81.8	88.1	84.5
1.2.1 General Sales & TT	13.1	13.2	33.3	32.9	33.4
1.2.2 Selective Sales Taxes	25.9	15.1	13.1	15.4	21.5
1.2.3 Import Duties	9.5	23.5	27.4	28.4	24.3
1.2.4 Export Duties	11.4	29.2	6.1	2.0	0.1
1.2.5 Licence Taxes	1.0	0.7	0.6	0.5	0.1
1.2.6 Property Transfer Fees	0.7	1.7	1.3	4.8	3.9
1.2.7 Other Taxes	21.3	0.0	0.0	4.2	1.2
Total	100.0	100.0	100.0	100.0	100.0

Source: Central Bank of Sri Lanka

Revenue from taxes on personal and corporate incomes contributed 15.5 per cent of the total revenue in 1993. In order to reduce the heavy burden of personal revenue tax, a gradual reduction in income tax rates have been effected since the early 1980's. It was expected that this measure would help reduce tax evasion and to leave a larger surplus in the hands of tax payers for increased investment. The share of personal taxes increased from 3 per cent in 1980 to 6 per cent in 1993. In the meantime, taxes on corporate income showed a decline in its share from 13.7 per cent in 1980 to 9.5 per cent in 1993.

Non-tax revenue contributed about 15.7 per cent of the total revenue in 1993. A major items in this category is interest income in respect of loans on-lent by the Government to public enterprises. The other non-tax revenue sources are Central Bank profits and surplus of trading enterprises.

13.2 Government Expenditure

The Government expenditure consists of current and capital expenditure items (Table 13.3). Current expenditure is used to meet payments on salaries and wages, other goods and services, interest payments and transfer payments. The major components of capital expenditure are acquisition of financial and fixed assets, capital transfers and repayments of loans. During the period 1981-93, the total expenditure increased at a compound rate of 14.5 per cent per annum. The rapid increase in current expenditure at the rate of 17.5 per cent was mainly responsible for the rise in overall expenditure. The annual increase in capital expenditure was only 9.2 per cent during this period. As a result, the share of capital expenditure fell from 45 per cent in 1981 to 25 per cent in 1993 in contrast to the increase in current expenditure from 55 per cent to 75 per cent during this period.

Table 13.3
Composition of Government Expenditure

	Rs. Mn				Percentage Share			
	1981	1985	1990	1993	1981	1985	1990	1993
Current Expenditure	14650	32644	71770	100951	55	59	73	75
Capital Expenditure & Lending	11820	22529	26386	33593	45	41	27	25
Total	26470	55173	98156	134544	100	100	100	100

Source: Central Bank of Sri Lanka

The pattern of Government expenditure has changed over the years depending on the possibilities in the fiscal operations. A higher priority was given to develop infrastructure and economic services during the period from 1978 until about 1988. Accordingly, larger sums of resources were diverted to economic services relatively to social services. In 1985, about 39 per cent of the total expenditure was allocated to economic services, while social services had only 22 per cent (Table 13.4). The trend has reversed since 1989. By 1993, the expenditure for economic services was only 20 per cent whereas social services had a share of 32 per cent. The rapid rise in expenditure on general public services and interest payments also contributed to the fall in the proportion of economic services.

Table 13.4
Functional Allocation of Expenditure

	Rs. Mn.				Percentage Share			
	1981	1985	1990	1993	1981	1985	1990	1993
General Public Services	2986	9807	21559	31649	11.3	22.0	21.3	23.5
Social Services	7564	12149	27468	43430	28.6	27.9	27.6	32.3
Economic Services	11446	21494	23935	26463	43.2	24.4	28.1	19.7
Other	4474	11723	25193	33001	16.9	25.7	23.0	24.5
Total	26470	55173	98155	13453	100.0	100.0	100.0	100.0

Source: Central Bank of Sri Lanka.

Around one third of the current expenditure was utilised for social services (Table 13.5). Current expenditure on social services rose at a compound rate of 16.8 per cent during 1981- 93. This was mainly due to the increased expenditure on welfare schemes, consisting of food and kerosene stamps, Janasaviya and mid-day school meals. About 20 per cent of total current expenditure was spent for such welfare schemes in 1993. Other social services included education (11 per cent) and health (6 per cent). A considerable increase in expenditure on general public services was evident during 1981 - 93. Its share increased from 17 per cent in 1981 to 27 per cent by 1993 largely as a result of the rise in defence expenditure, which accounted for about 15 per cent of current expenditure in recent years. A decline in the absolute levels of current expenditure on economic services, particularly with respect to transport and communications, can be observed from 1990 onwards. Interest payments account for about one fourth of current expenditure.

The bulk of the capital expenditure has been diverted to economic services (Table 13.6). However, the share of economic services declined from 84 per cent in 1985 to 67 per cent in 1993. This was mainly due to the completion of a major part of the Mahaweli Project by mid-1980's which had absorbed about one third of the total capital expenditure earlier. Thus, the capital expenditure on agriculture and irrigation has declined since the second half of the 1980's. Capital expenditure on energy and water supply also declined in recent years. On the contrary, capital expenditure on transport and communication showed an increase since 1994.

Table 13.5
Current Expenditure of the Government

	Rs. Mn.				Percentage Share			
	1981	1985	1990	1993	1981	1985	1990	1993
General Public Services	2468	8768	7942	27564	16.8	26.9	25.0	27.3
Civil Administration	1613	3095	6622	7405	11.0	9.5	9.2	7.3
Defence	479	4614	6736	1541	3.3	14.1	9.4	15.3
Public Order & Safety	376	1059	4585	4746	2.6	3.2	6.4	4.7
Social Services	5766	10323	24449	37355	39.4	31.6	34.1	37.0
Education	1695	3523	8529	11211	11.6	10.8	11.9	11.0
Health	879	1773	3685	5711	6.0	5.4	5.1	5.7
Welfare	3117	4889	11973	20148	21.3	15.0	16.7	20.0
Housing	7	13	0	0	0.0	0.0
Community Services	68	125	262	285	0.5	0.4	0.4	0.3
Economic Services	2095	2544	5137	4111	14.3	7.8	7.2	4.1
Agriculture & Irrigation	1392	1313	982	1483	9.5	4.0	1.4	1.5
Fisheries	19	31	46	107	0.1	0.1	0.1	0.1
Manufacturing & Mining	134	255	181	403	0.9	0.8	0.3	0.4
Energy & Water Supply	0	7	345	93	0.0	0.0	0.5	0.1
Transport & Communication	303	592	2600	1129	2.1	1.8	3.6	1.1
Trade & Commerce	120	94	159	203	0.8	0.3	0.2	0.2
Other	127	252	824	693	0.9	0.8	1.1	0.7
Other	4321	11009	24241	31920	29.5	33.7	33.7	31.6
of which: Interest	3738	7428	20668	28926	25.5	22.8	28.8	28.7
Total	14650	32644	71770	100950	100.0	100.0	100.0	100.0

Source: Central Bank of Sri Lanka

Table 13.6
Capital Expenditure of the Government

	Rs. Mn.				Percentage Share			
	1981	1985	1990	1993	1981	1985	1990	1993
General Public Services	518	1039	3617	4085	4.4	4.6	13.7	13.2
Civil Administration	456	859	1599	3463	3.9	3.8	6.1	10.3
Public Order & Safety	62	180	2018	622	0.5	0.8	7.6	1.9
Social Services	1798	18260	3019	6075	15.2	8.1	11.4	18.1
Education	421	930	1042	2845	3.6	4.1	3.9	8.5
Health	141	318	1279	1353	1.2	1.4	4.8	4.0
Welfare	19	11	25	1084	0.2	0.0	0.1	3.2
Housing	1137	459	513	604	9.6	2.0	1.9	1.8
Community Services	80	108	160	189	0.7	0.5	0.6	0.6
Economic Services	9351	18950	18798	22352	79.1	84.1	71.2	66.5
Agriculture & Irrigation	4941	9370	5215	5093	41.8	41.6	19.8	15.2
of which: Mahaweli Project	3816	7233	1810	2221	32.3	32.1	6.9	6.6
Fisheries	154	108	133	124	1.3	0.5	0.5	0.4
Manufacturing & Mining	386	1114	120	1457	3.3	4.9	0.5	4.3
Energy & Water Supply	1210	1492	6132	4268	10.2	6.6	23.2	12.7
Transport & Communication	1544	4805	4319	9303	13.1	21.3	16.4	27.7
Trade & Commerce	105	156	205	364	0.9	0.7	0.8	1.1
Other	1011	1905	2674	1743	8.6	8.5	10.1	5.2
Other	153	714	952	1081	1.3	3.2	3.6	3.2
Total	11820	22529	26386	33593	100.0	100.0	100.0	100.0

Source: Central Bank of Sri Lanka

13.3 Government Savings

Government savings are equivalent to its current account surplus, which is the excess of total revenue over current expenditure (Table 13.7). Ideally, the Government should be able to generate adequate savings to finance its capital expenditure, so that there will be no Budget deficit. But this is not practicable very often and therefore, most Governments often carry deficit financing to meet current and/or capital expenditure requirements. The Current Account has been in deficit

continuously since 1988. In other words, current expenditure was higher than the total revenue. As a ratio of GDP, the annual average of current expenditure during 1988 - 93 amounted to 21.6 per cent as against the revenue ratio of 20.6 per cent. This resulted in an average current account deficit of 1 per cent of GDP over that period.

The low level of Government savings is a typical feature of many developing countries. In contrast, most fast growing East Asian economies have maintained high public sector savings mainly by restraining Government consumption. For example, Singapore's public savings rose from 5.5 per cent of GDP in 1974-80 to 18.5 per cent in 1981-90. Malaysian's public savings increased from an average of 3.2 per cent of GDP in 1961-80 to 10.3 per cent in 1981-90. Thailand's public savings was high in the 1980's, i.e. 8-15 per cent.

13.4 Deficit Financing

As discussed above, Government expenditure has risen rapidly since the early 1980's. This increase was restrained to a certain extent in recent years by curtailing capital expenditure, but current expenditure continued to rise. The total expenditure rose from Rs. 28 billion in 1981 to Rs. 139 billion in 1993 (Table 13.7). The total revenue and grants increased from 17 billion in 1981 to 107 billion in 1993. As a ratio of GDP, the total expenditure in 1993 was 27.9 per cent compared with the total revenue and grants ratio of 21.5 per cent. The resulting budget deficit (after grants) was equivalent to 6.5 per cent of GDP. This was relatively lower in comparison with the budget deficits prevailed in the early 1980's.

Several significant changes can be observed with regard to the financing of the budget deficit. Until the beginning of the 1990's, there had been increased reliance on foreign financing. This was an outcome of the limited availability of financial resources in the domestic market and larger capital inflows for infrastructure development in the 1980's. During that decade, nearly one half of the deficit was financed through foreign sources.

The financing pattern started to change in the late 1980's with the adoption of financial sector reforms. In particular, Treasury Bills became a popular financial instrument. As a result, by 1993, it was possible to finance nearly 70 per cent of the budget deficit through domestic market borrowings. It is also significant to note that the dependence on bank borrowings declined considerably in recent years. Bank borrowings financed 37 per cent of the deficit in 1981 and it declined to 1 per cent in 1990. In the meantime, non-bank borrowings, which financed only 14 per cent of the deficit in 1981, rose rapidly to meet 88 per cent of the deficit by 1993.

Table 13.7
Government Fiscal Operations

	1981	1985	1990	1993	1981	1985	1990	1993
	(Rs. Mn.)				(In percentage of GDP)			
Total Revenue & Grants	17496	39556	74661	106520	20.6	24.4	23.2	21.5
Total Revenue	14755	36249	67964	98495	17.4	22.3	21.1	19.8
Tax	13696	30442	61206	87274	16.1	18.7	19.0	17.6
Non-tax	1079	5807	6758	11221	1.3	3.6	2.1	2.3
Grants	2721	3307	6697	8025	3.2	2.0	2.1	1.6
Expenditure & Lending								
Minus repayments	28014	55234	99814	138604	33.0	34.0	31.0	27.9
Current	14649	32645	71771	100951	17.2	20.1	22.3	20.3
Capital	11252	21530	19529	33777	13.2	13.3	6.1	6.8
Lending minus repayments	2113	1059	8514	3876	2.5	0.7	2.6	0.8
Current Account	126	3604	-3807	-2456	0.1	2.2	-1.2	-0.5
Budget Deficit (before grants)	-13239	-18985	-31850	-40190	-15.6	-11.7	-9.9	-8.1
Budget Deficit (after grants)	-10518	-15678	-25153	-32084	-12.4	-9.7	-7.8	-6.5
Financing	10518	15678	25152	32084	(Percentage Share)			
Foreign Financing (net)	4880	7109	11644	9855	46.4	45.3	46.3	30.7
Gross Borrowings	5487	8898	16550	16839	52.2	56.8	65.8	52.5
Repayments	-607	-1789	-4906	-6984	-5.8	-11.4	-19.5	-21.8
Domestic Financing	5638	8569	13508	22229	53.6	54.7	53.7	69.3
Non-Market Borrowings	344	-3232	305	0	3.3	-20.6	1.2	0.0
Gross borrowings	381				3.6	0.0	0.0	0.0
Repayments	-37				-0.4	0.0	0.0	0.0
Market Borrowings	5294	11801	13203	22229	50.3	75.3	52.5	69.3
Non-Bank	1447	5919	12946	28307	13.8	37.8	51.5	88.2
Gross Borrowings	2379	11019	20233	48543	22.6	70.3	80.4	151.3
Repayments	-932	-5100	-7287	-20236	-8.9	-32.5	-29.0	-63.1
Bank	3847	5882	257	-6078	36.6	37.5	1.0	-18.9
Gross Borrowings	3917	7582	4962	-9713	37.2	48.4	19.7	-30.3
Repayments	-32				-0.3	0.0	0.0	0.0
Use of Cash Balances	-38	-1700	-4705	3635	-0.4	-10.8	-18.7	11.3

Source: Central Bank of Sri Lanka

13.5 Public Debt

The outstanding total public debt increased at an annual compound rate of 22 per cent from Rs. 31 billion in 1978 to Rs. 484 billion in 1994 (Table 13.8). As a ratio of GDP, the public debt rose from 73 per cent in 1978 to 97 per cent in 1993. The share of foreign debt increased from 47 per cent in 1978 to 56 per cent in 1993. Increased inflow of foreign loans in the form of project and non-project loans contributed to this changing composition. The share of domestic debt declined from 53 per cent in 1978 to 44 per cent in 1993. In relation to GDP, foreign debt increased from 34 per cent in 1978 to 54 per cent in 1993 and domestic debt from 38 per cent in 1978 to 43 per cent in 1993.

Table 13.8
Composition of Outstanding Government Debt

Source	1978	1980	1985	1990	1993
(Rs. Million)					
1. Foreign Debt	14573	22276	69453	176883	269883
Domestic Debt	16368	29070	62611	133897	213685
Total	30941	51346	132064	310780	483568
(In percentage of GDP)					
1. Foreign Debt	34	33	43	55	54
2. Domestic Debt	38	44	39	42	43
Total	72	77	82	97	97
(Percentage share)					
1. Foreign Debt	47	43	53	57	56
2. Domestic Debt	53	57	47	43	44
Total	100	100	100	100	100

Source: Central Bank of Sri Lanka

The short-term debt instruments, namely Treasury Bills and Central Bank Advances rose from Rs.3.6 billion in 1978 to Rs.108 billion in 1993 reflecting a rise in its share in total debt from 22 per cent to 50 per cent during this period (Table 13.9). This was mainly due to the popularization of the Treasury Bills since the late 1980's. In contrast, long-term debt instruments consisting of Rupee loans showed a decline in its share from 74 per cent in 1978 to 50 per cent in 1993.

Table 13.9
Domestic Debt

	1978	1980	1985	1990	1993
1. Debt Instruments					
Rupee Loans	12049	17611	36570	54676	105707
Treasury Bills	2635	9800	22280	67968	97196
Central Bank Advances	956	1319	3633	6408	10502
Other	728	340	128	4845	280
Total	16368	29070	62611	133897	213685
2. Ownership					
2.1 Banking Sector	3785	11510	25155	48254	90135
2.1.1 Central Bank	3138	10988	24299	37080	16480
2.1.2 Commercial Bank	647	522	856	11174	73655
2.2 Non-Bank Sector	12583	17560	37457	85643	123550
2.2.1 Market Borrowings	11884	17232	37338	85448	123392
Savings Institutions	2956	4822	17079	24190	38752
Provident, Insurance					
& Pension Funds	5166	7138	14598	50807	76012
Private Business &					
Individuals	98	83	144	701	7925
Other	3724	5189	5517	9750	703
2.2.2 Non-Market Borrowings	699	328	119	195	157
Total	16368	29070	62611	133897	213685

Source: Central Bank of Sri Lanka

Recent developments in the Government security market are reflected in the ownership of the Public Debt. The holdings of the Central Bank declined from Rs.37 billion in 1990 to Rs.16 billion in 1993 reflecting the expansion of the Treasury Bills and Rupee Securities Market. Commercial banks and other accredited dealers increasingly participated in popularising Treasury Bills in the primary and secondary markets.

CHAPTER 14

TRENDS IN FOREIGN FINANCE

Foreign finance has increasingly become important in Sri Lanka following the liberalisation of foreign trade and exchange. The foreign trade policy in Sri Lanka is based on free market principles. The liberalisation has been extended gradually to cover a larger number of transactions during this period. Recently, all current account transactions including exports, imports and service transactions like foreign travel, investment income and insurance are fully liberalised. As a result, foreign transactions have become significant in domestic economic activities. For instance, the total value of exports and imports represents about 60 per cent of the Gross Domestic Product (GDP). Service related foreign transactions have also risen. Meanwhile, continuous increase in inward remittances mainly from the middle east workers, has eased the external payment situation.

As a result of these favourable developments, the current account of the balance of payments, which consists of flows of merchandise trades, services and transfers has improved in recent years. As a ratio of GDP, the current account deficit fell from 5.1 per cent in 1984-1988 to 2.3 per cent in 1989-1993.

Another significant feature in foreign finance is the considerable increase in foreign capital inflows to private and public sectors in recent years. Factors such as favourable investment climate, high domestic interest rates attracted foreign capital in the form of direct investments to various projects, portfolio investments in the share market and private lending. The capital inflows to the public sector have risen in recent years largely as a result of increased investments in infrastructure developments. Private and public sector capital flows are reflected in the capital account of the balance of payments. The net capital flows amounted to about 6.2 per cent of GDP in 1989-1993 as against 4.9 per cent in 1984-1988. Since the net capital inflows were more than sufficient to finance the current account deficit, the overall balance of payments has been in surplus continuously since 1990.

14.1 Exchange and Trade Liberalisation

The liberalisation process in Sri Lanka began in 1977. During the period 1977-1988, most of the quantitative restrictions and import quotas were eliminated. The liberalisation process accelerated during the second phase of 1989-1992.

Significant liberalisation measures were adopted in 1993. Accordingly, a series of exchange relaxations were implemented with respect to current account transactions. Under these reforms, surrender requirements in respect of export proceeds were removed. Also authorised dealers of foreign exchange were permitted to issue foreign exchange more freely for purposes such as holiday and business travel, education abroad and employment abroad.

In March 1994, all existing restrictions on current account transactions were completely removed and certain degree of relaxations was introduced for the capital account. A complete liberalisation of current account was effected under Article 8 of the International Monetary Fund Agreement. Current transactions relate to payments and receipts which involve trades in goods (merchandise) and services. Capital transactions relate to payments and receipts, which involve transfer of real or financial assets by purchase or sale. Main features of the liberalisation package are a relaxation of import controls and simplification of the procedures. Almost all import transactions could be effected through commercial banks. In terms of the March 1994 liberalisation measures, authorised dealers are permitted to release foreign exchange without restriction for all current (non-capital) transactions, exercising their judgment and discretion after satisfying themselves with the *bona fide* of such requests. Meanwhile, exporters have been given the freedom to repatriate their export proceeds and to credit the proceeds to any type of rupee or foreign exchange currency account in the form of current savings, fixed deposits in the domestic buying unit of any commercial bank in Sri Lanka or retain the proceeds abroad. As regards service transactions, commercial banks are permitted to issue foreign exchange to persons resident in Sri Lanka at their discretion for the purposes of travel abroad, foreign education, miscellaneous purposes and issue of foreign currency notes to travellers.

Certain relaxations have also been introduced for capital account transactions. Emigrants are allowed to repatriate specified amounts of their assets. Restrictions with regard to direct investment abroad by residents and such investments in Sri Lanka by non-residents have been removed to a great extent. Similarly, liberalisation has been adopted with respect to portfolio investments abroad by residents and such investments in Sri Lanka by non-residents. Remittances of dividends, profits, interest and rent are also permitted.

In the absence of direct controls on foreign trade and services, major policy instrument that has been used to influence the foreign sector is the exchange rate. Since 1977, Sri Lanka has adopted a flexible exchange rate system. At present, the Central Bank quotes spot buying and selling rates for the US \$ for transactions with

commercial banks. These rates are based on factors such as international exchange rate movements and domestic interest rates and inflation. Commercial banks are free to determine their own exchange rate quotations.

The recent experiences of Sri Lanka with regard to international financial management reflects the implications of interactions among different sectors, namely foreign trade, domestic production, government finance, money supply and exchange rates. As the economy opens up further, these interactions tend to become more prominent. Foreign trade and exchange policies implemented in recent years have been based on market oriented economic principles which are geared to permit private sector participation in the economic process. With the liberalisation of the economy, it is observed that external sector plays a crucial role in the economic activities.

14.2 Pre-reform Period

The general strategy during the immediately preceding years of the first oil crisis of 1973 was to use direct administrative controls to achieve the internal and external stability. These controls were partly responsible for a deceleration of economic growth: the annual average growth rate during 1970-1972 was only 2.8 per cent. A major reason for this was the poor performance of the export sector. On average, export earnings (in SDR terms) fell by about 4 per cent annually during this period due to unfavourable commodity prices and a continuous decline in the export volume.

External pressures emerging from the sluggish export growth and the deterioration of the terms of trade in 1970-1972 was not fully reflected in the balance of payments on account of a severe compression of imports by means of quantitative restrictions. The current account deficit as a ratio of the GDP was less than 2 per cent during that period. The re-introduction of import controls in 1970 contributed to narrow down the external deficit. Mobilization of foreign borrowings to finance the external deficit and the use of devaluation to adjust the balance of payments were considered to be unfavourable during that period.

As a major external adjustment measure, import substituting industries were promoted through import controls during the early seventies. Under that inward looking strategy, the development of such industries was considered as a major vehicle to promote economic growth as well as to achieve a better balance in the external sector. Accordingly, importation of goods was administered by a foreign exchange budget committee. In addition, prohibitive tariffs were imposed on

Table 14.1
A Summary of Balance of Payments of Sri Lanka, 1970-93
(SDR Million)

Year	Trade Balance	Net Service Receipts	Net Transfer Receipts	Current Account Balance	Net Non-Monetary Capital	Overall Balance	Current A/C Balance as % of GDP
1970	-53	-17	11	-59	56	17	-2.56
1971	-47	-2	14	-35	68	41	-1.54
1972	-38	-2	11	-29	39	19	-1.29
1973	-39	7	11	-21	57	35	-0.87
1974	-158	10	35	-113	69	46	-3.82
1975	-168	11	66	-91	48	-51	-2.90
1976	-73	12	56	-5	61	49	-0.16
1977	29	29	59	117	32	153	0.73
1978	-144	6	63	-75	133	65	-2.42
1979	-363	37	148	-177	164	35	-6.79
1980	-758	40	211	-507	306	-166	-16.40
1981	-693	10	308	-375	341	12	-10.00
1982	-890	-16	387	-519	471	-24	-11.93
1983	-801	-56	416	-441	420	...	-9.15
1984	-453	-66	468	-51	335	+297	-0.87
1985	-711	-133	434	-410	328	-111	-6.97
1986	-649	-109	395	-363	279	-65	-6.67
1987	-525	-121	381	-265	234	-62	-5.12
1988	-568	-114	392	-290	194	-64	-5.58
1989	-530	-123	405	-248	216	-67	-4.39
1990	-518	-72	398	-192	345	+138	-3.23
1991	-726	-65	441	-350	475	+152	-5.37
1992	-740	-23	457	-306	381	+133	-4.47
1993	-825	31	517	-277	609	+375	-3.75

Source: Central Bank Annual Reports.

domestically producible imports. Tariff concessions were granted for raw materials and other imports that are required for the production of import substitutes. A disadvantage of this tariff structure was that it encouraged the development of industries with a larger import content and thereby depressed domestic "backward

linkage" industries. Restrictive monetary measures were also used to contain non-essential imports. As a result of these measures, import payments fell by 10 per cent (in SDR terms) during 1970-72 and helped to contain the balance of payments deficit despite a fall in export earnings.

The external payments position began to deteriorate considerably following the OPEC oil price increase in 1973 and adverse implications of that shock were evident throughout the period 1973-76. The current account deficit (in SDR terms) expanded more than five fold in 1974: the deficit was equivalent to 4 per cent of the GDP and by the end of that year gross external assets were sufficient to finance only two months' imports. Import controls supplemented by a tightened monetary policy were continued to be used as the major policy instrument and as a result, the current account deficit was contained in 1975 and 1976.

The policies adopted until the latter part of 1977 were characterised by a regime of quantitative restrictions (QRs). As noted earlier, all imports other than essential items were subject to stringent import controls. Administrative procedures of that system became complex over years causing delays and errors in approving imports. In particular, private industrial entrepreneurs had to fulfil a number of administrative prerequisites to obtain approval for their capital and intermediate good imports. Partly as a result of these difficulties, a considerable degree of underutilization of import allocations was evident during the QR regime. For instance, actual imports amounted to only 52 per cent of total exchange allocations in 1976.

The shortage of inputs caused an underutilization of production capacity and had adverse implications for economic growth. Also, inadequate supply of imported products in the domestic market led to accrue black market premia to import licence holders and caused an upward shift in domestic prices of imports. The rise in import prices relative to export prices has a tendency to depress bias toward exports. The QRs also had spill-over effects on private expenditure since importation of consumer and capital goods for the use of private sector was restricted during the import control regimes.

14.3 Post-reform Period

The introduction of a broad programme of economic reforms based on a market oriented and "outward looking" strategy in 1977 indicated a turning point of economic growth and balance of payments adjustment process. These reforms were geared to transform the economy from one in which almost all economic activities were controlled by the public sector to one in which the private sector plays the leading role through the allocation of resources by market forces. The objective of

the stabilization programme was to raise economic growth and employment and to restrain inflation and external payments deficits.

The export sector was expected to provide the impetus to raise economic growth as well as to achieve the external balance. It was necessary to induce the bias towards exports to promote the export sector. For this purpose, the import controls were abolished and the currency was devalued in 1977. The import liberalisation was accompanied by a reform of the tariff structure. It was envisaged that these policy measures would improve the competitiveness of the country and thus, provide the basis for export-led growth.

Table 14.2
Trade Indices of Sri Lanka, 1970-84 (1978 = 100)

Year	Exports			Imports			Terms of Trade ^{1/}
	Volume	Price	Value	Volume	Price	Value	
1970	107	17	19	77	16	18	106
1971	104	17	19	68	17	16	98
1972	102	17	18	67	18	16	94
1973	103	20	24	60	24	18	82
1974	89	31	25	42	42	28	72
1975	107	29	32	52	49	34	58
1976	102	34	36	57	44	24	78
1977	94	55	51	73	54	31	102
1978	100	100	100	100	100	100	100
1979	101	109	109	123	152	140	72
1980	99	126	119	140	217	205	58
1981	102	129	132	145	282	208	46
1982	112	119	131	150	309	221	38
1983	109	165	155	180	375	241	44
1984	127	207	231	185	415	265	50

Source: Central Bank of Sri Lanka.

$$^{1/} \text{ Terms of Trade} = \frac{\text{Export Price Index}}{\text{Import Price Index}} \times 100$$

The impact of the policy reforms of 1977 on the economy was evident in the subsequent years. Despite a considerable increase in import payments following the trade liberalisation, the current account deficit was equivalent to only 2 per cent of the GDP in 1978. Apart from the export growth resulted from the new policy package, an improvement in the terms of trade also helped to ease the external payments situation. Export earnings (in SDR terms) rose by 4 per cent in 1978 and 12 per cent in 1979. This was partly a reflection of the improvement in the export competitiveness following the exchange and trade reforms.

Industrial exports, particularly garment exports, has shown a considerable expansion since 1978 mainly due to the availability of a wide range of incentives to these industries. During the period 1979-81, export earnings from industrial products (in SDR terms) rose annually by 40 per cent.

The expansion of the export sector contributed to economic growth; the average annual rate of growth of the GDP was 7.6 per cent during 1978-79 as compared with a 3.6 per cent increase in 1976-77. The share of exports in the GDP increased from 18 per cent in 1977 to 31 per cent in 1978. Thus, the improvement in the export sector stemmed from the structural adjustments had a favourable impact on economic growth during this period.

Like other non-oil producing developing countries, Sri Lanka too experienced a second oil price shock in 1979-80. As a result, the current account deficit of the balance of payments increased to 16 per cent of GDP in 1980. This external shock coincided with the adjustment strategy, in which it was crucial to maintain a substantially high level of domestic savings and investments so as to carry out the development programmes and thereby to achieve a higher rate of economic growth. The domestic investment ratio increased to 34 per cent in 1980 and a higher rate was maintained since then. But the domestic savings ratio remained at a low level during 1970-83, partly as a result of an increase in import payments. In consequence, the domestic resource gap remained at a higher level during this period as shown in the Table 14.2.

It is significant to note that export growth outstripped the rise in imports. During the last decade, exports grew by 7.4 per cent per annum, as against the increase in imports of 4.6 per cent. This trend helped to contain the trade deficit. The trade deficit, as a ratio of GDP, declined from 16.6 per cent in 1983, to 10.9 per cent in 1988 and to 10.8 per cent in 1993.

The major items in the services account of the balance of payments are port transportation and insurance services, travel and investment income. The expansion

of foreign trade and improved port facilities tended to raise the receipts from port services. Foreign exchange earnings from travel showed an increase owing to the growth of tourist industry. As a result of the liberalisation of foreign travel the travelling abroad have risen. However, the recovery of tourist industry since 1990 has helped to generate a surplus in the travel account. Investment income in the services account includes, payments and receipts with respect to interest, profits and dividends. This account has been in deficit owing to the high level of interest payments on foreign debt and repatriation of profits and dividends. The country receives interest income mainly from the investments of foreign reserves in international markets.

The transfer account in the balance of payments mainly consist of a private remittances made by Sri Lankans abroad and official outside drafts. Private inward remittances rose by about 11 per cent per annum during the last 5 years. This was due to the increase in the number of Sri Lankan employees working abroad and their confidence in the country's financial stability and attractive domestic interest rates. As a result of the relaxation of restrictions on transfer of assets by non-resident Sri Lankans, there has been an increase in the outflows since the middle of 1994. However, the rise in inflows of transfers was faster than the increase in the outflows, resulting in a net surplus in the transfer account. Official transfers have shown a decline in trend since the mid 1980's, partly, as a result of the completion of major infrastructure projects which absorbed considerable amounts of foreign grants.

The export growth coupled with increased service earnings and inward remittances helped to contain the current account deficit in recent years. The current account deficit as a ratio of GDP declined from 9.1 per cent in 1983 to 5.6 per cent in 1988 and to 3.8 per cent in 1993. Since 1990, net capital inflows have been more than sufficient to finance the current account deficit. This resulted in a surplus in the overall balance of payments from 1990 onwards. This surplus in 1993 amounted to SDR 362 Million.

14.4 Foreign Trade

In the context of market-oriented economic policies, foreign trade transactions in Sri Lanka are to be determined by market forces. Country's economic policies are based on an export-oriented growth strategy, and accordingly, the export sector is the driving force behind the growth process. A variety of incentives have been granted to the export sector, particularly, to the non-traditional exports. These incentives include tax concessions, export duty rebates and exchange facilities.

The impact of these policies are reflected in the export growth. Industrial exports rose at a rate of 23 per cent in 1989-1993. This was largely a result of the increase in Government exports by 25 per cent per annum. Other industrial exports increased annually by 24 per cent during the last 5 years. In contrast, the Agricultural Export sector remained stagnant. These trends brought about considerable changes in the export structure during the last 15 years. Industrial exports which had a share of less than one fifth of total export earnings in the late 1970's now account for nearly three fourths of the earnings. On the contrary, agricultural exports, which represented over three fourths of total export earnings now have a share of only one fifth of total export earnings. However, it may be noted here, that the net value-added of industrial exports is relatively low due to the high import content.

As mentioned earlier, imports have risen continuously as a result of trade and exchange liberalisation and increased economic activities. Overall imports grew at a compound rate of 9 per cent per annum during the last 15 years. The rise in intermediate and investment goods which are required for production purposes is particularly significant. The major items in the intermediate goods category are raw materials for garments industry, crude oil products, chemicals and various other inputs. The main items in the investment goods category are machinery, transport equipment and building materials. Consumer goods which include durables and non-durables rose at a relatively slow pace. As a result, intermediate and investment goods have become more important in the export structure. Intermediate goods, which had a share of about one third of total imports in the late 1970's, now hold a share of more than one half. The share of investment goods is about one fourth. Consumer goods had a share of over one third of total imports in the late 1970's and this share is now only about one fifth of total imports.

14.5 Private Capital Inflows

A significant increase in private capital inflow was observed after 1990. Private capital flows mainly take the form of direct investment into various projects, portfolio investments in the share market and long term loans. The total net inflow of private capital rose from 305 Million SDR's in 1989 to 790 Million in 1993. This increase was mainly due to the favourable investment climate here and high domestic interest rates. These capital inflows tended to raise the foreign reserves of the country.

14.6 Exchange Rate Movements

The exchange rates in Sri Lanka are determined through market forces with minimum intervention by the authorities. The exchange rate movement affect foreign

transactions. It is a recognised fact that the devaluation of the domestic currency encourages exports and discourages imports. An appreciation of the domestic currency has opposite effects. However, it may be noted that inflation tends to disturb this relationship in any economy. For instance, a devaluation of the foreign currency in nominal terms may be not enough to offset the impact of domestic inflation. Thus, the expected effects on exports and imports may not be achieved. Therefore, it is necessary to adjust the nominal exchange rate so as to compensate for inflation. The inflation adjusted inflation rates are known as real exchange rates.

14.7 Concluding Remarks

The foreign finance transactions in Sri Lanka are a reflection of market oriented economic policies adopted since the late 1970's. The contribution of foreign finance has expanded considerably during this period. The domestic economic activities are now closely linked with the foreign finance sector. The growth in foreign trade and services has been significant. In addition, inward remittances received from Sri Lankans working abroad has also made a noteworthy contribution to ease the payment situation. A major development in the foreign finance sector in recent years was the increased inflow of private capital reflecting the favourable investment climate. As the economy opens up further, the linkages with the rest of the world are likely to be strengthened.

CHAPTER 15

SUMMARY OF FINDINGS AND CONCLUSIONS

PART IV

CONCLUSION

PART IV

VI. Concluding Remarks

The first part of the book deals with the general principles of the law of contract. It discusses the formation of a contract, the performance of a contract, and the remedies available for breach of contract. The second part of the book deals with the law of tort. It discusses the elements of a tort, the defenses to a tort, and the remedies available for a tort. The third part of the book deals with the law of property. It discusses the acquisition of property, the transfer of property, and the protection of property. The fourth part of the book deals with the law of succession. It discusses the will, the intestate succession, and the administration of an estate. The fifth part of the book deals with the law of evidence. It discusses the admissibility of evidence, the burden of proof, and the standard of proof. The sixth part of the book deals with the law of procedure. It discusses the jurisdiction of the courts, the pleadings, the discovery, the trial, and the appeal.

CONCLUSION

CHAPTER 15

SUMMARY OF FINDINGS AND CONCLUSIONS

This study analysed the economic policies and trends in Sri Lanka during the pre-and post- liberalisation periods. The country has achieved remarkable progress with regard to physical quality of life and therefore, it is considered as a model economy in terms of social welfare indicators such as adult literacy rates and health. However, the economy has lagged behind the fast developing countries particularly those in East Asia, with respect to macroeconomic indicators such as GDP growth, savings and investments.

The period prior to 1977 was mostly characterised by stringent administrative controls on exchange and trade system, financial sector, resource allocation and price determination. Since 1977, these controls have been removed and thus, Sri Lanka led the liberalisation process in the South Asian region. These policies were aimed at implementing drastic structural reforms so as to deal with inherent structural bottlenecks and financial imbalances in the economy. These structural reforms were designed to achieve a satisfactory and sustainable economic growth to reduce inflation and to attain a viable balance of payments position.

The structural reforms introduced in Sri Lanka included domestic and external liberalisation measures, financial sector reforms, fiscal policy adjustments and public sector restructuring programmes. A major element of the reforms was the liberalisation of the exchange and trade systems. As explained in this study, Sri Lanka moved gradually from Phase I that existed in the early 1970's, under which stringent trade and exchange controls were in operation, towards Phase V by 1994 with the acceptance of Article VIII of the IMF Article of Agreement for Current Account convertibility. Capital transactions have also been relaxed to a certain extent. As regards financial sector reforms, direct monetary controls have been eliminated and interest rates are allowed to determine through market forces with minimum official intervention. The fiscal adjustments were geared to reduce current expenditure and to facilitate the development of infrastructure. A public sector restructuring programme was initiated to curtail expenditure and to privatise state-owned enterprises. Measures were also taken to expand the tax base while providing fiscal incentives to export-oriented enterprises.

Initially, the economy responded favourably to economic reforms with high investment and savings rates. But by the early 1980's macroeconomic imbalances emerged mainly as a result of fiscal deficits. The prolonged civil disturbances aggravated the economic instability. Consequently, the liberalisation process slowed down. The economy recovered somewhat after 1989 as reflected in the growth momentum. This trend helped to adopt substantial structural reforms in the early 1990's. However, macroeconomic imbalances mainly resulting from the widening fiscal deficits re-emerged by 1994.

As in the case of most developing countries, the savings capacity in Sri Lanka is limited and thus, domestic savings amounts to only about 12 per cent of GDP. Obviously, enhanced investments at the levels of around 30 per cent of GDP are necessary to attain a higher growth path. But the low domestic savings has become a major constraint to raise investments so as to sustain economic growth. The result is that the country had to rely continuously on foreign savings to meet the investment demand and this led to current account deficits in the balance of payments. Under the economic reforms, measures have been adopted to raise domestic savings. However, domestic savings have not shown any significant improvement. A series of concessions have been granted to private investors and these incentives led to considerable inflows of private capital into the country in recent years.

A salient feature of the production structure of the country is the gradual decline of the share of agricultural activities in the GDP during 1970-93. The share of economic services and industrial output increased over the period. Drop in the share of growth of the agricultural sector was largely due to the stagnation of the plantation sector. The output of paddy and minor food and export crops grew faster. As regards industrial sector, the private sector and foreign investors contributed substantially to accelerate its growth following the liberalisation. In the economic and social infrastructure sector, faster growth was recorded in electricity, gas and water, transport and communication, construction, health and education. In the case of economic services, the sub-sector of trade, banking and insurance showed a faster growth after the liberalisation.

The rapid growth of population until the 1970's contributed to the expansion of labour force. During that period employment remained stagnant due to slow economic growth. Agriculture has been the highest employment generating sector. But its share has fallen over the years, particularly after liberalisation and as a result the employment generation in the manufacturing sector has increased. The work force is projected to increase to about 8.4 million by the year 2000, adding about 150,000 persons to the labour force each year. Taking into account the already

existing backlog of unemployment which is around 1 million, the economy needs to provide employment for about 2 million people during the period 1994-2000, which is equivalent to about 286 thousand per annum. A District level survey on human resources revealed that there is a need to utilise the resources in their own areas to overcome the unemployment problem.

Wage in Sri Lanka are determined through different wage-fixing mechanisms. In the Government sector, wages are fixed by the Pay Commissions and Cabinet directives. Wages in the private sector and public corporations are influenced by Cabinet directives, Wages Board decisions and Collective Bargaining.

Trade unions have a considerable influence on the conduct of wage bargaining and on the relative wages of different groups of workers. It was necessary to revise the labour laws following the liberalisation to provide a conducive climate to private sector and foreign investors. According to the labour productivity estimates made in this study, output per man is considerably high in the sectors of finance, electricity and transport. The labour productivity in the manufacturing sector has not shown any improvement since the 1980's. But in the agricultural sector, labour productivity showed a decline in the 1980's.

Inflation has been a major problem over the years. In addition to monetary expansion, supply side factors such as inelastic supply of food products, foreign exchange bottlenecks and financial constraints have contributed to accelerate inflation. It is observed that there is an urgent need to curtail the fiscal imbalance to bring down inflation.

The monetary policy in Sri Lanka is typical to an open developing economy. Following the liberalisation, direct monetary controls have been removed so as to facilitate the financial needs of market-oriented activities. Accordingly, interest rates have been allowed to be determined through market forces. Primary and secondary markets for Treasury Bills have been set up.

Traditionally, the financial system of the country consisted of the monetary authority, commercial banks and savings institutions. Following the liberalisation of the economy, new specialised financial institutions like merchant banks, leasing companies and venture capital firms have developed to meet the financial requirements. The capital market in Sri Lanka has progressed since the late 1980's following the financial sector reforms and inflow of foreign investments.

The economy reflected a considerable extent of financial deepening following the economic reforms. Financial savings in the form of narrow and quasi money have increased considerably since the early 1980's. The statistical estimates carried out in the study reveal that there is a close relationship between economic growth and real financial assets, on the one hand and real interest rates and real financial assets, on the other.

The fiscal policy strategy in the post-liberalisation period was aimed at shifting budgetary resources from consumption to investments and to provide incentives to private sector investments. Prudent fiscal operations are essential to maintain macroeconomic stability. Considerable budget deficits in the recent past have disturbed monetary management and thereby accelerated inflation.

Foreign finance has increasingly become important following the liberalisation of foreign exchange and trade. The growth strategy has been based on the outward looking approach which is geared to create a bias towards exports. The current account of the balance of payments has improved in recent years due to increased foreign exchange receipts from exports, services and transport. It is significant to note that export growth outstripped the rise in imports. Private inward remittances rose mainly due to transfers made by workers in the Middle East. Another significant development has been the considerable increase in private capital inflows in recent years, mainly due to high foreign investments in the share market and export processing zones.

Overall, Sri Lanka attempted to achieve a higher growth path through drastic structural reforms and liberalisation. However, the efforts were somewhat hampered by civil disturbances and macroeconomic imbalances. The continuing budget deficits have caused considerable monetary expansion thus fuelling the inflationary trend. Low level of domestic savings leads to increased reliance on foreign savings and causes balance of payments deficits. Therefore, early action is imperative to correct these imbalances so as to continue the liberalisation process and to overcome the unemployment problems through faster economic growth.

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