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STAFF STUDIES

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CENTRAL BANK OF CEYLON

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The Problems of a Multiple Currency System in a Developing Economy with Special Reference to Sri Lanka*

DAYAPALA WIJEWARDANE

I. Introduction

Multiple exchange rates have been used by developed and developing countries alike as an instrument of balance of payments policy. In recent years, however, the principal users of this device have come to be the developing countries. Of the 35 member countries of the International Monetary Fund who have been using some form of multiple exchange rates in 1971, 30 were developing countries.[1]

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* I am grateful to Drs. W. Rasaputram, C. A. B. N. Jayarajah, M. A. Fernando, L. E. N. Fernando and Mr. V. K. Wickramasinghe for very helpful comments on a previous draft of the paper. I am also thankful to Mr. Sumith Silva of the Ministry of Plantation Industries and Miss B. M. Tennekoon of the Industrial Development Board for their assistance. I am alone responsible for the views expressed and for any remaining errors.

1. International Monetary Fund, **23rd Annual Report on Exchange Restrictions**, Washington D. C. 1972.

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The I. M. F. maintains a considerable degree of surveillance over multiple currency practices of member countries since these are at variance with the Articles of Agreement. Yet, the persistence of these practices and the Fund's acceptance of them in certain circumstances signify their need, at least, as temporary devices.

In the allocation of resources, market mechanism does not operate with the same degree of efficiency in a developing country as in a developed economy owing, among other things, to the existence of structural rigidities. More particularly the set of prices that would bring about the best allocation domestically may not simultaneously promote external balance. When the foreign exchange demand persistently exceeds a country's ability to export it is often an indication of over-valuation of the currency. But in a developing economy it does not necessarily follow that such an over-valuation could be remedied by an uniform adjustment of the exchange rate. This is because the exchange rate that would enable the country to develop markets for minor exports may mean an under-valuation in terms of its major exports which often consist of primary products.[1]

For certain primary commodities in which developing nations specialise, income and price elasticities of demand in advanced economies have been found to be less than unity. But the situation is different in less developed markets where any rise in per capita incomes, over the prevalent low levels, often generate a growing demand for food, beverages and similar primary goods. When income and price elasticities differ as between different products and different markets an optimisation of

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1. N. Kaldor, 'Dual Exchange Rates and Economic Development' **Economic Bulletin for Latin America**, Vol. IX, No. 2 (November, 1964) pp 215-24.

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earnings cannot be achieved through the adoption of a unitary exchange rate.[1]

Moreover, with the existing income disparities within less developed countries a uniform rate adjustment is not likely to provide the necessary protection to the low income earner. Besides these considerations, an adequately priced exchange rate is a more efficient instrument in equilibrating the foreign exchange market than an administered system of controls. Quite apart from the burdensome problems of policing a complicated import and exchange control system and the increasing incidence of exchange malpractices the allocation of resources too tend to get distorted under such a regime.

These were among the major considerations in the introduction of the dual exchange rate regime - the Foreign Exchange Entitlement Certificate (F E E C) Scheme - in Sri Lanka in May 1968. This paper attempts to examine the problems of a multiple currency system in a developing economy in the light of Sri Lanka's experience. The fact that the scheme has been in operation for four years only imposes a serious limitation on its scope. It is further circumscribed by the fact that the FEEC scheme, in its original form operated, in fact, for two years only until the cancellation of the Open General Licence Scheme for imports in May 1970. As it would be shown below, the O. G. L. Scheme was a key constituent of the new policy package. These limitations should be taken note of when interpreting the results of the present study.

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1. For a pursuasive argument in favour of the adoption of multiple exchange rates by countries faced with this situation see C. A. B. N. Jayarajah - 'Problems and prospects with respect to the International Monetary System: Implications of alternative exchange rate systems for developing countries', **Central Bank of Ceylon Bulletin**, December 1969. pp 826-52.

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The main conclusions of this study are that:

I. Multiple exchange rates have particular advantages to a developing economy in forging a new resource allocation.

II. But its usefulness depends on the extent of distortions that exist in the economic structure. A multiple currency system should not be relied upon to correct severe maladjustments.

III. A multiple rate system in isolation is only of marginal usefulness. Unless fiscal and other domestic economic policies are closely geared to achieving the exchange rate objectives it could only create new distortions.

IV. There is the danger of a persistent temptation to surrender the original objectives as new problems emerge.

II. Historical background

Sri Lanka experienced progressively large basic deficits in her balance of payments during the period 1957–68.[1] These deficits did not pose payments problems as long as adequate external reserves were available; but the persistence of the deficits after around 1960, when all such assets had depleted, created severe problems for balance of payments management.

There were several factors that contributed to the aggravation of the foreign exchange situation. Sri Lanka's major exports encountered a secular price decline owing to the low income and price elasticities of demand in the major consuming countries. Con-

1. Basic balance defined to include the current account balance plus net long-term capital.

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sequently, the increase in the volume of these exports did not reflect in a corresponding expansion in the foreign exchange earnings of the country. During the later years a further deterioration seemed imminent when the output of major export crops too tended to stagnate.

Superimposed on this declining trend in earnings was the growth in import surplus emanating from both a high rate of domestic income generation through the prevalent inflationary conditions at home and abroad as well as a relatively high rate of growth in population.

A host of policy measures had been adopted during this period with a view to improving the external payments situation. Foreign exchange budgeting was introduced in 1962 with widened coverage in the later years. Accordingly, imports were restricted to the barest minimum level; export promotion measures were also introduced for both major and minor exports including a bonus voucher scheme for minor products in 1966. In 1967 the rupee was devalued by 20 per cent.[1] These and other ad hoc measures adopted during the period proved to be ineffective in restoring a tenable balance to external finances. Some of the measures such as the exchange rate adjustment were, in fact, capable of achieving, largely, long-term benefits while even policies such as import restriction proved to be ineffective in the short-run. This, in brief, was the background to the introduction of the FEEC scheme in May, 1968.

Under this scheme all foreign exchange transactions were divided into two groups. Transactions in the first group continued to take place at the par value rate of exchange while those in the second group were channeled through the newly created cer-

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1. Devaluation amounted to only 7 per cent in terms of the Sterling Pound to which the Sri Lanka Rupee is linked.

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tificate market.[1] Accordingly, exchange earnings arising out of transactions in the second group, surrendered to banks, received Rupees at the par value rate as well as Foreign Exchange Entitlement Certifiicates in an amount equal in value to the foreign exchange surrendered. Similarly, applicants for foreign exchange for payments in this group were also required to surrender certificates with a face value equal to the exchange applied for. The Certificates denominated in Rupees were transferable within 30 days of the date of issue and could also be surrendered to monetary authorities for encashment. Non-resident travellers were able to receive in rupees the cash value of the Certificates.

Foreign exchange receipts that were paid for at the official rate included earnings from the major exports — Tea (excluding instant tea) rubber and major coconut products – certain service transactions such as expenditures in Sri Lanka of foreign embassies and official capital receipts.

Payments through the official market included the so-called A category imports which included initially, Food Commissioner's imports of rice, flour and sugar and certain other essential consumer items, drugs, fertilizer, petroleum, imports of government departments and certain government non-industrial corporations (including the Ceylon Transport Board, Air Ceylon and the Port Commission) and imports necessary for cottage industries, co-operatives and other small scale producers. Service items in this category included passage and other exchange released for pilgrimages, certain life insurance premia, pensions and educational expenses. Foreign exchange sales to the government for interest payments and other service expenses abroad as well as official capital payments were to take place at the par value rate.

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1. For detailed working of the scheme see W. M. Tilakaratna 'How the FEEC scheme came to be introduced'. Industrial Development Board **Research and Industry**, March 1970, pp. 15-32.

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Exchange surrendered to the banks for all other merchandise exports and invisibles and in respect of private capital inflows were to be paid the value of Certificates in addition to the par value rate. Similarly applications for exchange for specified imports in the B Category which included in particular raw materials, components, spare parts and capital goods required by the private sector industry and fisheries, those for imports of government industrial corporations and certain non-industrial corporations as well as approved consumer imports not of an essential nature had to be supported by Certificates. Other payments in this category included most private invisible payments and all private transfers and capital outflows.

The B category was subdivided into two groups-mainly raw materials and producer goods to be imported under Open General Licence and other imports subject to quota restrictions requiring individual licences.[1] The premium on Certificates remained at 44 per cent upto June 1969, at 55 per cent upto November, 1972 and at 65 per cent since then.

The new foreign exchange scheme constituted a significant departure from the country's traditional adherence to a general unitary rate system. However, as noted earlier, such a departure found justification on several grounds.

---

1. Since introduction, there have been shifts in transactions from the official to the certificate market and vice versa. As at November 11, 1972, the A category imports included the following: **Food Imports:** Rice, Wheat flour, Wheat grain, Infants' Milk food, Dried fish, Masoor dhal, Corriander and Cumin seed; **Other Imports:** Fertilizer, Books & Periodicals and two wheeled tractors, raw material and machinery etc. for the manufacture or processing of fertilizer, Wheat flour and Infants' milk food.

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The main policy objectives of the FEEC scheme could be summarized as follows:[1]

I. To enable the country to fix the exchange rate for the Rupee at a more realistic level while at the same time protecting the critical consumer and producer sectors of the economy;

II. To reform the existing system of import control and allocations with a view to enabling the local industries that were operating below capacity to reach more efficient levels of production;

III. To stimulate the export of minor products; and

IV. To divert to official sources some of the foreign exchange that flows into the black market.

In the following sections an attempt is being made to examine how far these objectives have been realised.

III. Developments since the introduction of the scheme

There were a number of developments in the economic scene since the introduction of FEECs which exerted a considerable impact on the economy. These factors appear to have militated heavily against the efficacy of the scheme. There were three such developments of special significance:

1. Gamani Corea 'The threefold objectives of the FEEC scheme', Ceylon Daily News, 21 May 1968; W. M. Tilakaratna, 'How the FEEC Scheme came to be introduced' op.cit; Annual Report of the Central Bank of Ceylon for 1968.pp.19–25, 219–221; Speech by the Minister of Finance Hon. U. B. Wanninayake in the House of Representatives, Hanzard Vol.78 No. 10, 24th May, 1968, pp.1870–75.

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I. Sharp deterioration of the balance of payments situation;

II. Expansionary fiscal policy of the government and its income redistribution measures;

III. Suspension of the Open General Licence scheme in May, 1970;

The success of the new foreign exchange scheme in promoting domestic industrial activity and reorienting domestic resource allocation depended, to a large measure, on the availability of imported investment and intermediate goods. But any significant improvement in foreign exchange earnings, through the stimulating effect of the FEEC scheme, could not be achieved in the short-run. While this itself tended to widen the deficit in the balance of payments two further factors contributed to the mounting imbalance. These were (a) the progressive increase in the public sector imports which was not directly related to the new incentives offered under the FEEC scheme, and (b) the 'programming' for an enhanced inflow of foreign aid in the exchange budget rather than seeking aid to meet a deficit already apparent. The outcome of these developments was a sharp increase in Sri Lanka's gross external indebtedness as shown in Table III. 1. Total indebtedness increased from Rs. 1420 million to Rs. 3450 million, or over two fold between the years 1967-72. Of this, over a third consisted of short-term debts in 1972.

Overseas borrowing could play a positive role in promoting economic growth by supplementing domestic investible resources. To the extent that these borrowing consist of long term loans more of current earnings could be diverted for development since the claims on such earnings in servicing of the debts are minimal. In other words, only the interest charge and a moderate amortization payment is due on long-term loans since repayments are spread over a long period of time

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TABLE III. 1

Gross External Indebtedness of Sri Lanka, 1965 — 72[1]

(Rs. Million)

Year	(a) Long — Term					(b) Short — Term					Total (a + b)
	Sterling Loans net of Sinking Funds	Project Loans		Commodity Loans	Total (a)	I. M. F. Drawings Outstanding	Borrowings from foreign banks	Payments Agreement debit balances	Supplier's Credits	Total (b)	
		I.B.R.D.	Other								
1965	57.8	139.3	250.2	—	447.3	180.9	—	0.6	—	181.5	628.8
1966	55.0	139.2	381.9	81.4	657.5	271.3	—	30.3	—	301.6	959.1
1967	55.5	170.1	347.7	302.9	876.2	376.0	57.1	110.4	—	543.5	1,419.7
1968	53.3	161.9	371.7	450.0	1,037.1	635.5	28.6	197.8	117.4	979.3	2,016.4
1969	50.4	153.3	351.1	844.6	1,399.4	625.9	255.9	185.0	176.3	1,243.1	2,642.5
1970	42.9	144.1	361.8	1,019.1	1,567.9	523.8	411.5	75.2	273.2	1,283.7	2,851.6
1971	39.9	135.9	528.5	1,183.2	1,887.5	506.0	333.8	18.3	250.4	1,108.5	2,996.0
1972[2]	38.0	131.0	560.3	1,567.5	2,296.8	466.1	330.5	7.5	349.4	1,153.5	3.450.3

Source: Central Bank of Ceylon.

1. Amounts outstanding end of each period.
2. Provisional

Note: Following exchange rates have been used:

1965 - 67 = U. S. $ 1 = Rs. 4.76
1968 - 71 = U. S. $ 1 = Rs. 5.95
1972 = U. S. $ 1 = Rs. 6.40

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Moreover, almost all such loans carry at least a few years of grace during which time no amortization is required. On the other hand, short-term loans have to be repaid in full normally in less than five years. When short-run obligations constitute a sizeable share of the foreign debt the exchange allocation needed for servicing also becomes relatively large,[1] as evidenced by Table III.2. It could be seen that, with progressive increases, of a total amortization of Rs. 1014.0 million 87 per cent consisted of short-term debt repayments in 1972.

TABLE III. 2
Service Payments on the External Debt, 1965-72

(Rs. Million)

Year	(a) Amortization		(b) Total (a)	(c) Interest	Total (b + c)
	Long-term	Short-term			
1965	40.7	55.3	96.0	24.5	120.5
1966	30.2	77.0	107.2	24.0	131.2
1967	44.4	17.9	62.3	32.5	94.8
1968	60.8	174.4	235.2	41.7	276.9
1969	77.0	284.3	361.3	68.4	429.7
1970	112.9	598.2	711.1	99.7	810.8
1971	96.2	965 4	1061.6	113.5	1175.1
1972[1]	124.0	890.0	1014.0	120.0	1134.0

1 Provisional. Source: Central Bank of Ceylon.

While the debt service obligations were claiming an ever increasing share of exchange earnings the country's ability to create the necessary export surplus was vitiated by another adverse development, This was the sharp deterioration in the terms of trade.

1. With fluctuating or stagnating export earnings this could cause severe balance of payments management problems. See D. Avramoric Et. al **Economic Growth and External Debt**; Baltimore, 1964.

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The terms of trade index which was 100 in 1967 declined to 75 by 1972. While export prices continued to remain at somewhat the same level, the principal cause for the deterioration was the unprecedented rate of increase in import prices. Within the span of these five years import prices increased over 50 per cent.

This increase in import prices is the result of several factors. The important among these were (a) the high rate of inflation in advanced economies causing a rise in the price of their exports, (b) rising freight charges, (c) the devaluation of 1967 and the effective depreciation of the Rupee resulting from the FEEC scheme in 1968 and the currency realignments that took place in 1972 all of which led to higher rupee prices, (d) a progressive increase in the share of imports financed through aid and trade credits where there was a high concealed cost involved, and (e) the likely tendency to over-invoice imports.

The virtual stagnation of export earnings coupled with the inability to contain the volume of imports within the country's earning capacity, caused severe balance of payments problems. On the other hand the heavy debt burden of the country necessitated a greatly increased capital inflow. This was essential both to sustain, at least a restricted flow of essential supplies as well as to maintain external confidence needed to obtain a high gross captial inflow.[1] The vicious circle so created tended to compound the foreign exchange crisis faced by Sri Lanka.

The foreign exchange problem affected considerably, the growth pattern that was envisaged under the FEEC scheme. But these problems were exacerbated by a second factor namely the ever increasing inflationary pressure within the economy. Of the several causes for

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1. Barend A de Vries highlights several such ramifications of external indebtedness. See "Debt - bearing capacity of developing countries". **Banca Nazionale Del Lavaro,** March 1971, pp. 65 – 88.

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TABLE III. 4

Net expansionary impact of government Fiscal Operations. 1964/65–1971/72

(Rs. Million)

	1964/65	1965/66	1966/67	1967/68	1968/69	1969/70	1970/71	1971/72[1]
1. Net Cash Deficit	430.4	566.0	606.8	715.7	787.6	935.6	1083.3	1285.7
2. Deficit financed from expansionary sources.2	34.7	122.4	56.1	267.4	179.0	427.9	218.1	138.9
3. 2 as % of 1	8.1	21.6	9.2	37.4	22.7	45.7	20.1	10.8

Source: Central Bank of Ceylon, Annual Report, various years.

1 Provisional.

2 Items included are (a) Domestic market borrowing from the banking system;
(b) Decline in cash balances and foreign aid counterpart funds;
(c) Decline in US Aid Counterpart funds.

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this tendency, the most important was the continuing deficit financing of government budgets. It was not only that the budgets were consistently unbalanced but most of these deficits were financed from expansionary sources. Table III. 4 provides data of the extent of deficit financing during the period 1964/65 – 1971/72. On average over Rs. 175 million a year was drawn from expansionary sources. While these magnitudes are large in relation to the national income of the country it must be viewed in the background of the multiplier effect of continued deficit financing since 1956 as well as the regime of import restrictions which prevented the inflationary pressure escaping through imports.

There is no realistic indicator of the changes in the general level of prices. In terms of the Colombo Consumers, Price Index the price level increased from 114.8 in 1967 to 153.5 in 1972 or by 33.7 per cent. But this index is not capable of reflecting the actual rise in prices since it is weighted down by the inclusion of certain subsidised items while its coverage is also limited to a particular class of consumer.

It was not only the directly inflationary potential of deficit financing that contributed to the price hike. Some of the income redistribution measures that were embodied in budgetary expenditure proved to be an important source; in particular the sharp increaee in social welfare expenditures and transfer payments along with wage adjustments tended to add considerable pressure on prices.

The ultimate success of the new exchange policy depended to a large extent on the expansion of the OGL Scheme to cover a larger area of imports. On a conservative estimate (see Table III. 5) based on the growth of GDP, Lanka's import capacity should have been supplemented by at least another Rs. 500 million a year during the period 1968-72 to obtain an appreciable extent of import liberalisation.

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TABLE III. 5

Estimates of Demand for and Supply of Foreign Exchange, 1968 - 72.

Rs. Million

	1968	1969	1970	1971	1972[4]
1. GDP.[1]	9,930	10,857	11,760	11,966	12,799
2. Foreign Exchange Demand[2]	3,476	3,800	4,116	4,188	4,480
3. Foreign Exchange Supply[3]	2,910	3,385	3,481	3,758	3,879
4. 3 as % 2	83.7	89.1	84.6	89.7	86.6
5. Balance requirement	566	415	635	430	601

Source : Central Bank of Ceylon.

[1] At current factor cost prices
[2] Assuming 35% of GDP. Average for 1958 - 60 was 38.9%
[3] Current earnings plus gross capital inflow.
[4] Provisional

For such an increase to take place either export earnings should have increased or the capital inflow should have been enhanced. although the inflationary situation in the advanced economies led to a rise in the prices of Sri Lanka's imports it did not create a concommitant increase in the demand for her exports. Foreign aid inflows, on the other hand, were substantial; yet it fell short of the requirements. Moreover, with the autonomous increase in the public sector imports as well as of other A category requirements it was the residue that tended to get eliminated with the narrowing of import capacity; and OGL imports constituted this residue. The OGL Scheme was eventually cancelled in May 1970 barely two years after its inunciation. Consequently all imports were brought under individual licensing.

These were the major developments in the economic scene since the introduction of the FEEC Scheme. Some of these it could be observed, were purely autonomous developments while others were the results of government policy decision. Together, however, they influenced considerably the operative impact of the Certificate Scheme.

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IV. Operation of the FEEC Scheme

The suceess of the FEEC Scheme in achieving the desired objectives has necessarily to be considered within the context of the developments mentioned in the previous section. The following analysis is confined to the private sector since investment here is determined entirely by incentives whereas public investment is more or less autonomous.

1. Industrial Development

The reform of the existing system of import regulation and the stimulus that was consequently to be imparted for capacity utilization in industry was one of the most important considerations in introducing the Foreign Exchange Entitlement Certificate Scheme It would be convenient to discuss this aspect first. The issue of fixing the exchange rate at a realistic level would be taken up later in this section.

Consequent upon the restriction of imports and under the active promotion of the government, a wide range of import subtituting industries appeared in Sri Lanka since early 1960s. The output in these industrial units, however, was closely linked to the availability of imported inputs. The strangulating effect of continued import restrictions was clearly evident in most of these industries operating well below capacity by 1968.

The Open General Licence Scheme meant the free availability of a wide range of raw materials and producer goods. In addition, licences for complementary requirements were freely issued under the B category. Besides these, there were other benefits provided such as the removal of licence fees on most imports. To assist the small scale industrialist the import of raw materials by those establishments with a turnover of less than Rs 100,000/- per annum was allowed without the requirement of Entitlement Certificates. All industrial exports, on the other hand, qualified to receive Certificates.

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The effect of the new incentives was immediately apparent. As seen from Table IV.1 the value of industrial production increased from Rs. 954 million in 1967 to Rs. 1,399 million in 1968 and to Rs. 2,442 million by 1972 over two-fold increase in five years. At constant 1967 prises the increase was less marked but it was a significant 85 per cent. Similarly, the contribution to GNP of manufacturing origin increased from 12.8 per cent in 1967 to 14.0 per cent in 1972 at constant 1959 factor cost prices.

TABLE IV. 1

Value of Industrial Production, 1965-72.

	(1) Value of Production	(2) G. N. P. (1959 prices)	(3) GNP of Manu-factured origin (1959 prices)	(4) (3) as % of (2)
1965	847	7,551	937	12.4
1966	850	7,818	1,008	12.9
1967	954	8,120	1,052	12.8
1968	1,399	8,901	1,154	13.0
1969	1,627	9,316	1,261	13.5
1970	1,945	9,695	1,335	13.8
1971	2,239	9,779	1,379	14.1
1972[1]	2,442	10,023	1,401	14.0

Source: Central Bank of Ceylon Annual Reports.

1. Provisional.

Although the increase in industrial production has been spectacular its success cannot be determined on that criterion alone. In view of the fact that sizeable exchange allocations had been made for the import of intermediate requirements of the industrial sector and considering the basic objectives of the FEEC Scheme its success has to be measured more in terms of foreign exchange earnings or savings. Table IV.2 carries information relating to the production and export of industrial goods.

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TABLE IV. 2

Production and Export of Manufactured Goods 1965-1972

(Rs. Million)

	(1) Value of L/C's opened for OGL imports	(2) Value of Industrial production	(3) Value of industrial exports	(4) (3) as % of (2)
1965		847.0	6.1	.007
1966		850.3	7.0	.008
1967		954.2	7.8	.008
1968	308	1398.9	12.0	.009
1969	374	1626.8	10.7	.007
1970	135	1945.0	18.0	.009
1971	—	2239.4	17.5	.008
1972[1]		2442.0	n. a.	—

1. Provisional.

Sources: Central Bank of Ceylon-Annual Reports.
Ceylon Customs Returns.

It is seen that along with the expansion of industrial production the value of exports too have increased from Rs. 7.8 million in 1967 to Rs. 17.5 million by 1971. But the fact that causes concern is that in 1967 Sri Lanka exported 0.008 per cent of the industrial production in value terms, and in 1971 too the share remained the same. In relation to the cost of intermediate goods imported to feed these industries too this rate of earning appears to be insignificant.

On the other hand, the export of precious stones where a major break-through was envisaged under the FEEC Scheme too appears to have had disappointing response until the establishment of the State Gem Corporation.[1]

1. The value of precious stones and semi-precious stones exported were -

(Rs. '000)

1965	1966	1967	1968	1969	1970	1971	1972
4080	3884	3471	2028	674	4284	3446	12300

Source: Customs Returns.

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There were several reasons for the failure of manufacturing industry to expand their exports. For an export drive an industrialist often has to make special investment in research, design and packaging; assemble a specialised sales force, delegates considerable authority and has to launch an entirely different sales campaign. In short he takes on additional risks and new overhead costs which could be recovered only over a long period of successful exporting. With such additional costs an industrialist would not take to export trade unless it paid adequate dividends or there are compelling reasons such as the inability to find domestic sales opportunities[1].

In this instance, the Rupee premium paid to exporters proved to be an ineffective instrument of export promotion. It was ineffective for several reasons. Firstly, there existed a lucrative domestic market which was the direct outcome of long years of import restrictions. Super–imposed on this were persistent inflation and income re-distribution both of which promoted a higher propensity to consume.

Table IV.3 contains data relating to the domestic consumption of industrial products. Private consumption expenditure increased from Rs. 5,881 million in 1965 to Rs. 9,773 million in 1972 or by an annual compound rate of 7.5 per cent. Of this, expenditure on locally produced industrial goods increased from Rs. 1,346 million to Rs. 3,492 million during the same period or by 14.6 per cent every year. Stated in different terms, in 1965, 22.9 per cent of private expenditure was on these goods while in 1972 the share had increased to 35.7 per cent.

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1. A. O. Hirschman, 'The political economy of import substitution industrialisation in Latin America; **Quarterly journal of Economics.** Vol. LXXXII, No 1 (July, 1968) pp. 1–32.

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The intensity of domestic demand was of such an order the manufacturers were often able to fix whatever prices the traffic could bear using their monopoly power. For instance the price of an electric bulb in normal household use increased by over 120 per cent between the years 1968 and 1971 ; other electrical appliances, foot wear and leather goods, among a host of other items, recorded similar, if not larger increases. Price increases were held in check for some time when price controls were introduced on a number of items in late 1970. But here too there were frequent complains that manufacturers used dubious ways such as lowered quality to defeat the controls. When the embargo was lifted ultimately in July 1972 immediate increases averaging around 25 per cent took place[1]. In short the ability of the Industrialists to exploit a captured domestic market which had sufficient purchasing power did not leave much incentive to look elsewhere for sales opportunities.

TABLE IV. 3

Private Consumption Expenditure on locally produced Manufactured Goods, 1965-72 (at current market prices)

(Rs. Million)

	1965	1966	1967	1968	1969	1970	1971	1972	Annual compound Growth Rate
1. Private Consumption Expenditure	5881	6274	6677	7928	8698	8910	8849	9773	7.5
2. Expenditure on locally produced industrial goods	1346	1483	1625	2152	2811	2720	3032	3492	14.6
3. (2) as % of (1)	22.9	23.7	24.3	27.1	28.9	30.5	34.3	35.7	

Source: Central Bank of Ceylon—Annual Reports.

1. Central Bank of Ceylon Bulletin, August 1972.

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Secondly, with severe restrictions on the import of consumer goods and on other current payments such as for foreign travel a manufacturer could not obtain the type of 'incentive good' that would have stimulated him to expand exports. FEECs received did not carry any other benefit than additional rupees; and more rupees were of little use in the absence of the needed goods and services. Such a situation often provide the ideal climate for under-valuing of exports and maintaining foreign currency balances abroad. There is, however, no adequate direct evidence to establish such a conclusion with regard to industrial exports as is shown later for agricultural commodities. But on the other hand, if it exists in the commodity market there is no a priori reason to exclude the possibility in manufactured exports.

TABLE IV. 4

Capacity Utilization in Industry, 1968-70

(Percentage)

	1968	1969	1970
1. Food, Beverages and Tobacco	33.5	40.1	43.3
2. Textiles, Wearing apparel and made-up garments	26 0	26.2	25.2
3. Chemical and Chemical products	70.3	68.1	69.5
4. Leather, Rubber, Wood and Paper	52.8	72.5	71.9
5. Non-metallic mineral products and products of petroleum and coal ..	61.7	57.6	57.4
6. Base Metal Products	41 4	22.6	29.9
7. Machinery (except electrical) and transport equipment	71.3	72.4	74.4
8. Electrical machinery, apparatus, Appliances and Supplies	20.8	26 1	27.3
9. Miscellaneous Manufactures	21.5	24.6	28.7
10. Average	44.4	45.6	47.5

Source: Ministry of Industries and Scientific Affairs, **Capacity Utilisation Survey** (Private Sector Industries) Colombo, 1971.

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The third factor appears to be the inability of manufacturers to reach a high level of capacity utilisation. Hence they were unable to reduce their costs to a competitive level. Table IV. 4 contains information relating to capacity use.[1]

An interesting feature emerges from the data on capacity use. That is, that even during the heyday of free raw material imports-when the OGL scheme was in operation - the industrial sector has been operating well below capacity. This may be partly the result of optimistic entrepreneurs establishing large industrial units under the spur of severe import restrictions, without regard to the availability of cooperant factors of production such as technical know-how, skilled labour, future availability of raw materials or even the possibility of finding markets.

It could also be partly the result of the relative shortness of the period during which the OGL scheme was in operation. With market demand severely distorted by long years of scarcities it may be that the entrepreneurs were unable to assess the type of demand that would emerge after the scheme had operated for a few more years. Hence they were cautious not to expand output immediately.

On the other hand the low capacity use vindicates the thesis that with an over-valued exchange rate it enhances the financial profits of entrepreneurs to establish large capacity and use capital intensive methods of production. The extra profits is derived by over-invoicing such capital imports and dealing in the black market in foreign exchange. G. C. Winston estimates that in Pakistan, in 1970, additional 25.1 per cent profits were earned by industria-

1. The data had been collected by means of a questionnaire circulated by the Ministry of Industries. It is possible that in these figures the extent of capacity use is under estimated in the hope of obtaining larger allocations of import quotas.

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lists by this mean.[1] In a recent study relating to Sri Lanka, it was revealed that there has been a marked tendency, in industries established with foreign collaboration, to over-import not only capital goods but raw materials and components as well.[2]

The establishment of production units with capacity in excess of what is required by market potential also leads to capital waste while reducing employment opportunities. The fact that industries in Sri Lanka have established capacity, which they evidently never intended to utilise fully, tends to confirm this hypothesis. If this is so, it shows that the profitability in the black market operation could not be outweighed by the incentive of a Rupee premium.

Most new industries that were set up at the time when consumer imports were restricted were exclusively to substitute imports without any export horizon either on the part of the industrialists themeselves or of the government. Moreover, these were established largely by multinational firms or through other forms of foreign collaboration. In most such cases, either by tacit understanding or through specific agreement the local firms were restricted in entering into export trade.[3]

Besides these obstacles and disincentives there was little need to invest in research to gain higher productivity, with the captive home market providing adequate sales opportunities. Sri Lanka had not taken to export promotion in any significant

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1. Gordon C. Winston, 'Over invoicing, under utilization and distorted industrial growth'. **Pakistan Development Review** Vol. X No. 4 (Winter 1970)pp. 405-21. See also Frank C. Child, 'Liberalisation of the Foreign exchange market', Pakistan Development Review, Vol. VII. No. 2 (Summer 1968) p. 190.
2. L. E. N. Fernando, **Some Aspects of private foreign enterprise in Ceylon.** Unpublished Hull University, Ph.D. Thesis, 1971, Ch. VII.
3. L. E. N. Fernando, ibid.

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way either although promotional measures could not be treated with indifference since the type of export goods Sri Lanka had just started to manufacture has been the established trade of many developing countries in the region. In fact, a study group of investors who examined export prospects under the FEEC Scheme at its very inception considered that the measures were doomed to fail unless complementary action such as export promotion, and simplified export procedures too accompanied it.[1] These considerations lead one to the conclusion that although the new measures tended to promote industrial production per se, it was not capable of bringing about the necessary resource reallocation either for a break-through to exporting or, at the very least, for establishing a viable industrial sector.

2. Minor Agricultural Products:

In view of the longer gestation period and the fact that a significant share of minor agricultural production is in the hands of small holders it is after a considerable time lag that production incentives reflect themselves in increased exports. It should, however, be apparent at three different levels :-

1. An immediate increase in the volume exported;
2. A sustained increase in the volume of production; and
3. Sharp expansion in the area cultivated.

The analysis here had to be confined to five selected commodities owing to the paucity of data. These five commodities-cocoa, cardamoms, cinnamon, citronella and pepper - account for over 85 per cent of the value of minor agricultural exports.

A sharp and immediate increase in the export of cinnamon products and cardamoms is clearly evident since the introduction

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1. OECD, Business and Industry Advisory Committee, **Report on the Investment Climate in Ceylon, March, 1969.**

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of the Certificate Scheme (Table IV. 5). Pepper records a greater increase upto 1970 but by 1971 it has been almost wiped out of the export market. In respect of Cocoa and Citronella oil there has been a modest increase since 1967 but it could not recover to the level that prevailed in early 1960's.

If the period during which the scheme has been in operation is too brief to result in a sharp increase in exports it should have been at least reflected in increased output. Table IV. 5 which contains this information, however, does not point to a particular trend in this direction. Here too, cardamoms show a remarkable increase along with cocoa. The output of cinnamon and pepper have increased but the rate of increase has been less significant compared to the period prior to the launching of the new scheme. In the case of citronella oil on the other hand, there has been a marked decline.

A comparison of the two sets of figures - production and export - indicates that for all crops but pepper (to some extent until 1970) the export ratio has tended to decline since 1967 over that prevailed in early 1960's. In respect of cocoa, citronella oil and cardamoms, the trend is clearly marked where the output-export ratio has declined by more than 50 per cent while in cinnamon too the decline is not insignificant.

The apparent insensitivity of production and export of examined crops to the new incentives may, however, be the relatively long period of gestation required. Except for citronella where cropping is possible in six months time all other crops require periods of three to four years. Whether the failure of these products to respond stems from this time-lag could be established by examining the data of area planted. Table IV. 6 provides this information.

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TABLE IV. 5

Growth in Production and Export of Selected Commodities, 1962—1971.

(Cwt. '000)

Year	Cocoa			Cinnamon			Cardamoms			Pepper			Citronella Oil		
	1	2	3	1	2	3	1	2	3	1	2	3	1	2	3
	Produc -tion	Export	2 as % of 1	Produc -tion	Export	2 as % of 1	Produc -tion	Export	2 as % of 1	Produc -tion	Export	2 as % of 1	Produc -tion	Export	2 as % of 1
1962	232.1	47.2	20.3	126.3	58.7	46.5	27.9	3.0	10.7	126.8	0.9	0.7	138.7	26.4	19.0
1963	182.5	50.0	27.4	132.6	56.6	42.7	29.3	3.0	10.2	131.9	1.9	1.4	140.7	7.1	5.0
1964	228.1	38.3	16.8	169.4	57.1	33.7	20.6	2.8	13.6	189.0	11.0	5.8	83.1	6.8	8.2
1965	243.6	28.3	11.6	204.0	55.3	27.1	34.5	2.8	8.1	169.9	13.7	8.1	211.7	4.2	2.0
1966	278.4	42.5	15.3	142.5	54.8	38.4	62.5	2.5	4.0	191.7	6.0	3.1	230.0	4.0	1.7
1967	267.7	23.2	8.7	234.1	61.1	26.1	45.1	2.4	5.3	220.5	2.0	0.9	417.7	3.0	0.7
1968	248.7	34.8	14.0	234.7	79.1	33.7	55.5	2.5	4.5	96.0	16.2	16.9	88.2	2.7	3.1
1969	289.7	25.4	8.8	232.0	88.2	38.0	68.2	3.2	4.7	257.3	17.9	6.9	124.1	3.6	2.9
1970	308.3	30.0	9.7	246.2	83.8	34.0	67.7	4.0	5.9	274.6	16.9	6.1	135.2	3.8	2.8
1971	n. a.	30.1	—	n. a.	89.0	—	n. a.	3.7	—	n. a.	0.9	—	n. a.	3.7	—
Annual Compound Growth Rates															
1962—67	2.9	— 15.2		13.2	0.8		10.1	— 4.6		11.7	18.2		30.5	— 54.5	
1962—70	3.6	— 5.8		9.0	4.5		11.8	3.6		10.1	44.3		— 0.3	— 27.5	
1967—70	4.8	8.9		2.4	11.1		14.5	18.5		7.6	103.6		— 45.6	8.1	
1962—71		— 5.2			4.7			2.3			—			— 24.4	
1967—71		6.7			9.8			11.4			—22.1			5.4	

Source: Department of Census & Statistics; Ceylon Customs Returns.

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TABLE IV. 6

Estimated Acreage Under Selected Minor Crops 1962 - 1970

Year	Cocoa	Cinnamon	Cardamom	Citronella	Pepper	Total
1962	27,499	28,897	5,758	11,327	10,528	84,009
1963	26,204	27,823	4,882	13,541	11,112	83,562
1964	25,189	27,184	—	19,463	13,634	85,470
1965	26,245	29,461	4,064	19,465	13,643	97,878
1966	27,389	33,921	6,720	18,559	13,662	100 251
1967	25,964	36,463	8,064	18,709	14,717	103,917
1968	25,212	38,983	7,209	14,497	15,521	101,422
1969	28,315	43,916	7,641	15,339	14,217	109,428
1970	26,742	45,744	8,075	13,064	14,899	108,544
Annual Compound Growth Rates						
1962/67	-1.2	4.7	6.9	10.5	6.9	4.3
1962/70	-0.3	5.9	4.3	1.8	4.4	3.2
1967/70	1.0	7.8	0.1	-12.7	0.4	1.4

Source: Dept. of Census & Statistics.

Cinnamon shows a sharp increase in the area with a compound growth rate well above the historical rate In respect of cocoa there has been an increase in 1969 but it does not signify a particular trend. In fact, the area in 1966 was more than that of 1970. Cardamoms too show a similar increase and here too the rate of 0.1 was considerably below 4.3 per cent of the historical trend. There also does not appear to be any new impetus to the

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plantation of Pepper while for Citronella the scheme has not been able to stem the decline that began in 1964. The total estimated area under all these crops increased from 84 thousand acres in 1962 to 104 thousand in 1967 and to 109 thousand in 1970; while the rate of increase during the period 1962—67 has been a compound 4.3 per cent a year it had increased by only 1.4 per cent annually during the period 1967—70. If the additional incentives have indeed been effective the area under cultivation since 1967 should have actually increased at a rate well above that of the earlier years. The decline in the rate in such a context shows not only that the FEEC incentive has not been able to step up production but it has not even been capable of checking the decline in the rate of cultivation.

What factors have been responsible for inhibiting the FEEC Scheme from imparting a general stimulus to the minor agricultural sector? The host of reasons that tended to retard industrial exports undoubtedly exerted the same disincentive effect on these commodities. To recapture, the principal among these were domestic inflation and income redistribution along side import restrictions which tended to promote a high level of home consumption of these goods. The inadequacy of export promotional measures was another reason for producers concentrating on the home market.

Apart from these, there were additional factors that affected agricultural exports. Basic among these was the introduction of a new range of ad valorem export duties that tended to absorb a significant proportion of the benefit of a premium rate of exchange. In August, 1969 the duty based on volume exported was replaced by ad valorem duties ranging from ten per cent to forty per cent of the f.o.b. value (See Table IV.7).

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TABLE IV. 7
Export duties on selected minor products.

Export Commodities	Export duty which was abolished on 2.8.69	Ad Valorem rate of export duty effective from 3.8.69
1. Cocoa (raw)	Rs. 30 per 100 lbs.	40% of true f.o.b. Value
2. Cardamoms (with shells)	Rs. 100 per 100 lbs.	40% of true f.o.b. Colombo value
3. ,, (without ,,)	Rs. 200 per 100 lbs.	
4. Coir fibre (Bristle)	Rs. 1 per cwt. plus 6% of the f.o.b. Value	30% of true f.o.b. Colombo value
5. Coir fibre (Mattress)		
6. Cinnamon Quills	50 cts. per lb.	20% of true f.o.b. Colombo value
7. Cinnamon Chips	Duty Free	10% of true f.o.b. Colombo value
8. Citronella Oil	Duty Free	10% of true f.o.b. Colombo value
9. Graphite	Duty Free	25% of true f.o.b. Colombo value. (Increased to 50% in October, 1970)

Source: Ceylon Govt. Gazette Extraordinary No. 14864/18 of August 2nd, 1969.

In other words the exporters of Cocoa and Cardamoms in effect received only fifteen per cent as FEECs. When allowance is made for the exporters' expenses and profits not much would be left for transfer to the producer. It is worth observing that in commodities where the export duty was heavy the ratio of exports to production too tended to decline.

A high export duty could be used firstly, when the supply of a commodity is inelastic so that a price premium could not bring about a relative increase in gross earnings. Several countries, faced with this situation, have in fact used these profitably[1].

1. E. M. Bernstein, 'Some economic aspects of Multiple Exchange Rates, I. M. F. Staff Papers, Vol. I No. 2 (September 1950) pp. 224–37.

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Secondly, it could also be justified when the producers are not responsive to a price incentive, as it has been found in certain peasant economies, or when the existing prices are adequate to cause a sustained increase in production. These conditions do not appear to exist in the minor agricultural production sector in Sri Lanka.

It is evident that the rationale of introducing the new duty rates has been to siphon-off the windfall profits that would accrue to exporters of these commodities. This is of particular necessity when the collection and export of these items is concentrated among a few exporters, who may not pass on the benefit to the producers. However, the fact that production has not adequately responded to the incentives of the FEEC Scheme tend to confirm that the high duty rates have not been condusive to their expansion.

It is observable that even in commodities where the duty rates were not so stringent new planting has not taken place in any significant scale. This phenomenon calls into question the efficacy, in a developing economy, of a price incentive provided in isolation from other co-operating measures. The peasant farmer who accounts for a significant share of output is not in a position to utilise the price benefit fully in the absence of infra-structure facilities and more particularly the initial capital requirements.

A noteworthy feature that emerges from data presented above is that the decline in the export ratio in most items coincided with the intensification of restrictions on consumer imports. Since then a number of these commodities have been diverted to feed the industries that emerged to fill the vacuum created by import restrictions. Cocoa provides a case in point where almost the entire increase in the output has been absorbed by the domestic market. This is also borne out by the fact that the value of production in the 'Biscuits, cocoa, chocolate and sugar confectionary' group

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which largely consumes this raw material increased from Rs. 33.3 million in 1967 to Rs. 53.1 million in 1971 or by 61 per cent. A forty per cent ad valorem duty wihin this context, has been an invitation to divert potential exports to the home market. Another example is pepper, the export of which increased from 2,000 hundred weights in 1967 to 17,000 in 1970; but the volume exported in 1971 was an insignificant 0.9 thousand hundred weights. This was despite the fact that production that year continued to expand. It is noteworthy that pepper is the closest available substitute to chillies which is an essential ingredient for preparation of curries. In 1970 the import of chillies was severely restricted and the local distribution to consumers was brought under rationing and in March 1972 imports were banned. In a market backed by strong effective demand and starved of the often preferred imported product, even other commodities did not have to be perfect substitutes to find a ready market.

A further factor that has affected minor agricultural exports was the frequent increase in freight rates that tended to undermine their competitive position[1]. There have been other responsible factors as well. As in the case of industrial exports Sri Lanka has not undertaken in earnest any promotional plans for these agricultural commodities. There is also hardly any research done regarding fertilizer use or other conditions of plantation and for the use of more advanced and less expensive techniques of processing. One instance is Cinnamon oil the extraction of which is based on a process which is about 100 years old. Until recently there was no quality definition for Cinnamon Chips and Quills. But it has to

1. For instance, for Citronella oil frieght was increased in 1970 by 5 per cent to U. S. A., 7½ per cent to Australia and 12½ per cent to U. K, The following year it was increased by a further 10 per cent to U. S. A., 15 per cent to Australia, 12½ per cent to the Continent and 15 per cent to U. K. This was in addition to the general increases that took place frequently.

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be realised that the survival in an intensely competitive world depends largely on such research.

These above mentioned factors have obviously tended to lure the exporters of minor agricultural crops away from exporting enhanced quantities. While this trend itself is disheartening a further cause for concern is apparent in the recovery of proceeds on the modest scale of exports that has been taking place.

Table IV.8 presents data of average Colombo Market prices and f.o.b. Colombo prices in respect of selected commodities for the period 1967-71. The f.o.b. prices shown are inclusive of FEECs less duty ruling at the particular time. A further ten per cent deduction has been made from this price to allow for the costs and profits of the exporter. These costs include bank charges (since most of the exports are on DA or DP terms) charges for packing, transport, storage rents and dues and commissions of overseas agent. Ten per cent is indeed a conservative estimate of all such costs as well as exporters' profits.

It is interesting to note that for all commodities but Cinnamon Chips, the f.o.b. Colombo price has been consistently lower than the Colombo market price. It is also noteworthy that this situation existed prior to the introduction of the FEECs and that it continued despite the premium offered under the scheme.

The price differential is clear evidence that exporters tend to maintain foreign currency balances abroad by under-valuing exports. It is also borne out by the fact that there have been instances when exchange control authorities have been able to persuade exporters to enhance the f. o. b. values that were declared. If this is so, it indicates not only that the FEEC scheme has not been able to stimulate the production of minor products it has also not been capable of checking the tendency to under-value exports, and the related dealings in the black market in foreign exchange. This last aspect is considered in further detail in the next Section.

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TABLE IV. 8

Average Prices of Selected Agricultural Exports, 1967–71

(Rs. per pound)

Commodity	1967		1968		1969		1970		1971	
	Colombo Market	F.O.B. Colombo[1]	Colombo Market	F.O.B. Colombo[1]	Colombo Market	F.O.B. Colombo1	Colombo Market	F.O.B. Colombo[1]	Colombo Market	F.O.B. Colombo[1]
Cocoa	1.83	1.16	2.31	1.76	3.28	3.01	2.14	2.22	2.04	1.90
Cardamoms	10.54	9.88	18.09	14.99	28.51	26.52	29.03	26.23	15.07	14.62
Cinnamon Quills	4.88	4.09	5.05	4.73	5.51	4.39	4.58	4.40	3.87	3.82
Cinnamon Chips	0.46	1.23	0.80	1.39	0.77	—	0.48	1.57	0.51	1.70
Citronella Oil	2.28	2.20	4.23	3.86	6.31	—	6.03	5.84	6.96	6.60
Pepper	1.56	1.73	1.45	1.58	2.32	2.14	4.01	3.47	6.41	9.33

Sources: Central Bank of Ceylon Annual Reports; Ceylon Customs Returns.

1 F.O B. price plus FEECs less export duty and a further 10 per cent allowed for exporter's costs. (These include charges on bank credit–most of these exports were on D/A or D/P terms – packing, transport, storage, rents and dues, commissions of overseas agents as well as exporter's profits).

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3. Effects on the black market in foreign exchange

The existence of a black market is the obvious corollary of an over-valued exchange rate regime. To sustain such a rate various controls on foreign exchange expenditure have to be introduced. With the worsening of the balance of payments situation of a country there is often an intensification of such restrictions. The greater these restrictions are the further the stimulus imparted to the thriving of the black market since the demands on the black market also increase concurrently. The authors of the FEEC scheme did not however, envisage a complete elimination of the black market with the implementation of the new proposals. This was in view of the fact that a wide area of payments still continued to be regimented.[1]

No data, however, are available to determine the extent of the black market. The estimates of tourist expenditure in Sri Lanka could provide a useful indicator in this regard. Table IV. 9 shows the estimated and official receipts from tourism. It could be seen that whereas 68.4 per cent of estimated receipts leaked out to the black market in 1967 only 39.0 per cent was diverted in 1971. The progressive decline seems to suggest that the FEEC scheme has had a favourable impact in controlling the operations of the black market. It must be noted, however, that the calculation is based on a visitor expenditure survey carried out in 1967/68. Perhaps the same expenditure pattern did not continue through to 1971. The Economist Intelligence Unit, in fact, regards the estimate of leakage far too low and they considered a more realistic figure to be about double that rate.[2]

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1. Central Bank of Ceylon, Annual Report for 1968 p.209
2. Economist Intelligence Unit, **Quarterly Economic Review - Ceylon** No. 2, 1972 p.14.

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TABLE IV. 9

Receipts from Tourism-Estimated and Official (Net of Feecs)

(Rs. Million)

	1967	1968	1969	1970	1971
1. Estimated Receipts ...	18.7	21.6	32.4	36.8	33.3
2. Official receipts ...	5.9	10.5	17.0	21.5	20.3
3. Difference (1-2) ..	12.8	11.1	15.4	15.3	13.0
4. % leakage ...	68.4	51.4	47.5	41.6	39.0

Source: Ceylon Tourist Board, Annual Statistical Report, 1971.

The existence of a black market is also borne out by the failure of precious stones exports to respond to the offer of a premium exchange rate. In no year since the new scheme was launched did these earnings exceed the Rs. 4.3 million recorded for 1970 until the Gem Corporation stepped into export trade in 1972. The annual leakage into the black market, on the other hand, is estimated to be well over Rs. 100/- million.[1]

4. Fixing the exchange rate at a more realistic level

The objective of fixing the exchange rate for the Rupee at a more realistic level while protecting the low income groups can now considered in the light of the preceding analysis. It is true that the adjustment in the rate resulting from the channelling of a wide area of transactions through the Certificate market was not the equilibrium rate of exchange for the Rupee. This is evident in the continuing need to intensify foreign exchange restrictions and the existence of an aggressive black market.

1. Budget Speech for 1970-71 by Hon. N. M. Perera, Minister of Finance, October, 1970 p.58.

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Nevertheless, it was a major step in that direction. Its significance is enhanced in the context of the social and political constrains which had tended to support an over-valued exchange rate.

The FEEC proposals contained the requisite mechanism for adjustment to any variation in the value of the Rupee as reflected in the demand for and the supply of Certificates. But the use of this mechanism was limited to a brief period of one month since its introduction. This was the weekly tender system for the sale of Certificates that was abandoned in June, 1968.

One salutory development in this direction, however, is clearly evident. This was in the share of transactions that were routed through the official and the certificate market. As shown in Table IV. 1 the scope of the certificate market was widened every year. Thirty four per cent of current payments were effected through this market in 1969, 43 per cent in 1970 and 52 per cent in 1971. Consequent upon the budgetary proposals of 1972 the share is estimated to increase to 65 per cent in 1973. Current receipts through certificates too increased from 16 per cent in 1969 to 19 per cent in 1970 and 22 per cent in 1971. In 1972 the rate at which the Certificates are transacted was also increased from 55 to 65 per cent.

The rationale of leaving essential consumer imports in the A category, where no FEECs were levied, was to keep to a minimum the adverse effects on the cost of living, of the partial devaluation of the Rupee. In keeping to the original objective of expanding the B category transactions as well as under the constraint of the deteriorating payments situation more and more items were shifted to the Certificate market in the course of time as shown earlier. Essential food items, however, continued to be in the A category.

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TABLE IV. 10

Foreign Exchange Transactions, 1969 - 71

	(a) Total transactions - Rs. Million									(b) Per cent								
	1969			1970			1971			1969			1970			1971		
	Par Value	Certi-ficate rate	Total	P a Value	Certi-ficate rate	To al	Par Value	Certi-ficate rate	Total	Per Value	Certi-ficate rate	Total	Par Value	Certi-ficate rate	Total	Par Value	Certi-ficate rate	Total
Current receipts	1,837	341	2,178	1,839	432	2,271	1,765	488	2,253	84.3	15.7	100.0	80.9	19.0	100.0	78.3	21.7	100.0
Exports	1,741	168	1,909	1,795	221	2,016	1,701	264	1,965	79.9	7.7	87.6	79.0	9.7	88.7	75.5	11.7	87.2
Services1	96	173	269	44	211	255	64	224	288	4.4	7.9	12.3	1.9	9.3	11.2	2.8	9.9	12.8
Current payments	-2,007	-1,015	-3,022	-1,530	-1,166	-2,696	-1,256	-1,336	-2,592	66.4	33.6	100.0	56.8	43.2	100.0	48.5	51.5	100.0
Imports	-1,835	-820	-2,655	-1,384	-948	-2,332	-1,128	-1,110	-2,238	60.7	27.1	87.8	51.3	35.2	86.5	43.5	42.8	86.3
Services1	-172	-195	-367	-146	-218	-364	-128	-226	-354	5.7	6.4	12.1	5.4	8.1	13.5	4.9	8.7	13.7
Capital account and other (net)	846	-2	844	419	6	425	272	67	339									
Market surplus/ deficit	676	-676	—	728	-728	—	781	-781	—									

1 Including Private Transfer payments

Source : Central Bank of Ceylon

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But the rise in the cost of living could not be checked effectively as seen from the sharp increase of the index from 114.8 in 1967 to 153.5 in 1972 (1952 = 100). There were several developments that tended to offset the stabilising effect of the scheme. These were, (a) the continuing rise in import prices, (b) the inability to contain the effect of the chain of price increases emanating from the rise in the price of B category imports of both consumer and intermediate goods (c) the ensuing increase in incomes which helped in sustaining a high level of effective demand and (d) perhaps, more importantly, the overwhelming impact of inflation. While these and the emerging scarcities contributed to a de facto rise in the cost of living - more than what is revealed by the index - it must be recognised that leaving the basic essentials in the A category helped the low income earner to a considerable extent.

However, the success of the FEEC scheme cannot be measured on the basis of short - run advantages of this nature. The real test of success is whether foreign exchange earnings have been stimulated sufficiently to enable the country to meet her import requirements for supporting an adequate rate of economic growth. The foregoing analysis would have shown that four years of experience with the scheme does not lend support to a conclusion that it has brought about a significant reorientation of the relevant economic aggregates in this direction.

V. Conclusion

Several countries have adopted multiple currency systems in seeking a solution to their balance of payments problems; but there are only a few success stories. The two common grounds on which most of these schemes floundered were (a) "the maintenance of exchange rates at unrealistically over - valued levels, and (b) lack of reasonable monetary stability".[1]

1. Margret G. de Vries, "Multiple Exchange Rates: Expectations and Experiences". **I. M. F. Staff Papers,** Vol. XII, No 2 (July, 1965) pp 282-311.

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In Sri Lanka too, these two developments appear to have influenced the working of the FEEC scheme adversely. Unfortunately, for her, foreign exchange earnings continued to stagnate while claims on earnings accumulated at an accelerated rate. When the imbalance between the supply, and the demand for foreign exchange continued to widen the over – valuation in the rate too increased. But the FEEC scheme itself was designed with a built -in mechanism to maintain a realistic rate of exchange. This was to be achieved through two main devises (a) the weekly tender system for the sale of Certificates, and (b) the O. G. L. scheme for imports.

At the initiation of the scheme the Central Bank called weekly tenders for the sale of Certificates. This was meant to establish a realistic price for the Certificates, each week, based on the availability of funds and the prevalent demand and without any direct support of the monetary authorities. But under the pressure of the emerging balance of payment situation, this system had to be abandoned barely a month later in favour of a rate determined by administrative decision. With fluctuating exchange earnings and mounting demand generated by rising incomes a realistic rate of exchange could not be determined in this manner.

The O. G. L. scheme which was the counterpart of the rate adjustment, too, could not be sustained in view of the growing imbalance in the exchange market. The abandonment of these two devices removed the self adjusting potential of the FEEC scheme. A basic reason for the degree of success achieved in the multiple currency systems of Thailand, Costa Rica and Nicaragua was their continuous maintenance of realistic exchange rates. [1]

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1. Margret G. de Vries, 'Multiple Exchange Rates · ' op. cit.

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The new exchange scheme in Sri Lanka also suffered as a result of the fiscal policy of the country. When export incomes decline, ceteris paribus, the operation of the multiplier process causes a cumulative decline in domestic money incomes. Consquently, the demand for imports too falls pari passu with the decline in export receipts. But despite the existence of these conditions, as well as allowing for shifts in demand to home goods and increased savings, the failure to contain import demand implies that countervailing fiscal policy through which income generation was sustained, was a major causal factor in the external imbalance.

The expansionary fiscal policy effected the scheme's operation not only in generating a sustained level of import demand. It also tended to increase the cost of production of exports while promoting simultaneously increased domestic consumption of potential exports. The FEEC scheme itself had a dis-inflationary potential with the net revenue accruing to the government averaging over Rs. 400 million a year. But this would have been non-inflationary only if it was held in surplus or spent in ways that did not set inflationary forces in operation. The objective of a multiple currency system to bring about external balance cannot be realised unless domestic measures with a similar objective are adopted.[1]

The fiscal measures adopted since the introduction of the FEEC scheme constrains one to the conclusion that after a period, the original objectives of the scheme in bringing about external balance were thrust to the background and that revenue considerations tended to emerge with greater importance. This is evident in the introduction, in 1969, of a new range of ad valorem duties on a number of minor exports and also the reluctance to extend the facility to other deserving exports.

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1. See Jorge Marshall, 'Exchange Controls and Economic Development', in H. S. Ellis and H. C. Wallich (Ed) **Economic Development for Latin America** IEA, New York, 1961 – p. 437.

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Apart from the reasons considered earlier that affected different sectors of the economy, these were the main causes that inhibited the FEEC scheme from achieving the objectives it was designed for. The scheme could also have been geared more closely to deal with a number of other problems that the Sri Lanka economy was faced with. For instance, when imports to industry were allowed on more liberal terms this was not geared to any performance criteria such as export earnings, use of more domestic raw meterials or labour intensive methods. The use of foreign raw materials in industry, in fact, increased from 64.5 per cent in 1968 to 77.6 per cent in 1972.[1] It may, justfiably be that the authors of the scheme ignored such criteria in order not to complicate the issues involved in a unique experiment of this nature since these could be embodied progressively

A further feature of the scheme that is difficult to be reconciled is the facility afforded to industrialists with less than Rs. 100,000 turnover to import their raw material requirements at the official exchange rate. This could have been justified on the introduction of the scheme since small scale industrialists would find it difficult to mobilise sufficient finance to open Letters of Credit to get their import requirements. But the continuation of the facility amounts to an unwarranted subsidy to these industrialists, in view of the fact that their products too enjoy the same market and any exports would also be at the FEEC rate. It is also prone to exchange malpractices since an import licence in that category would command a very high market price.[2]

There were, in addition, frequent complaints that the FEEC scheme had led to the import of inessential consumer item such

1. Central Bank of Ceylon, Annual Reports, 1968 and 1972.
2. This was removed from the A category in November 1972.

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as used warm clothing, key chains and other fancy goods. In a country which had been starved of consumer imports, trade in such items is highly profitable particularly when there was excess purchasing power within the economy. Unless strict checks are imposed it is difficult to prevent the inflow of such goods when a package of import liberalisation takes place. These imports could, however, absorb, to a certain extent, the excess purchasing power that would have otherwise tended to distort the domestic production structure or would have been directed towards exportables. Anyhow, although their "advertising impact" has been large, expenditure in terms of foreign exchange has been hardly significant. However, the inclusion of at least one item in the preferred list of imports where no FEECs are levied appears to be very much against the objectives of the Scheme. This commodity is "dates" which is neither a consumer item that is regarded as essential nor an input to any such critical industry. If the preferential rate was applied to reciprocate the sale of Lanka's produce in date-producing countries it does not appear to be in the best interest of long term growth of the economy.[1]

In brief, the apparent inability of the scheme to achieve its broad objectives can be attributed to four main reasons. The first and the foremost was the group of internal and external developments – whether they were the outcome of autonomous or fortuitous circumstances or were contingent upon the government policy measures – which tended to rob the scheme of the basic conditions that were essential for its successful operation. The principal among these were the continued deterioration of the external financial situation and the build up of inflationary pressure within the economy. Secondly, and once again under the stress of the emerging foreign exchange situation, the abandonment of the tender system for the sale of Certificates and the cancellation of the OGL scheme for imports meant the removal of main corner stones of the entire scheme.

1. This was removed from the A category in November 1972

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Thirdly, a price incentive could be reduced to impotency unless cooperant measures are introduced simultaneously in order to overcome structurally based obstacles. These include institutional decfiiencies, land tenure system, cultivation methods, lack of financial assistance, need for research, complicated export procedures and a host similar problems. In Chile, a price differential of over 50 per cent sustained for 13 years faced with sluggish supply rerponse from agricultural producers owing to simillar reasons.[1] Sri Lanka has proved to be no exception. Finally, there were inherent deficiencies in the scheme itself which tended to impair its efficiency.

In many developing countries, as in Sri Lanka, there are two main structural parameters that need to be duly recognized in any medium or short term policy measure directed at restructuring the exchange rate. These are (a) the existing pattern of resource allocation where although an urgent need for diversification is underlined the ability to do so is severely circumscribed by the scarcity of capital, and (b) the diversity of income distribution and the particular regime of social welfare services. A long-term solution to a country's economic problem may lie, in fact, in the speed and effectiveness with which these problems are dealt with. But any drastic adjustment within this background could create severe social, economic and political problems.

It is in the above context that a multiple currency system could assume a new significance in bringing about the desired resource allocation and income distribution with a minimum of social costs Its success, however, would be determined by the existence of the necessary preconditions for its effective operation. If not any such measure could only carry the frequent epitaph: "too little! too late!."

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1. David Feli, 'Monetarists, structuralists and import substituting Industrialistation: a critical appraisal; in W. Bear and J. Kerstenetzky (Ed.) **Inflation and Growth in Latin America**, U. S. A. 1964. pp. 370-400.

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1. David Felix, "Monetarists, structuralists and import substituting industrialization: a critical appraisal" in W. Baer and I. Kerstenetzky (Eds.) *Inflation and Growth in Latin America*, U. S. A. 1964, pp. 370-400.

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Prospects for Improving the Financial Accessibility of Small and Medium Sized Industry and Overall Industrial Growth.

C. A. BALASURIYA

This paper makes an attempt to examine likely solutions to ease the burden to some extent, of the small and medium scale industrial sector, in the sphere of access to finance... The observations made here are a result of an investigation of an area in the economic structure of Ceylon, where scant attention has been paid to date, namely the adequacy and access to finance of small and medium sized manufacturing firms.[1]

The findings of this study underline the existence of a credit gap in the case of small and medium sized firms. It further

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1. The observations made in this paper are a result of three surveys conducted by the author.

(a) a questionnaire interview survey of all financial institutions and other service institutions.

(b) a questionnaire interview survey of 100 selected small & medium sized firms.

(c) a general interview survey of persons and institutions connected with industry.

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confirms that this general deficiency of credit was / is a result of a number of interlinking causes which for purpose of identification is demarcated into six sub groups.

(I) Institutional Gap

The absence of any properly constituted institution or institutions to (a) provide finance, especially long term funds, i. e. venture and risk capital, and capital for expansion, innovation and development: (b) educate, advise, direct and establish liaison.

(II) Fund Gap

The shortage of funds in the institutions, the meagreness of available short and long term credit flowing into this sector, shortage of funds in the financial market and the direction of funds from long term fund depositories, a part of which could have been made available to this sector.

(III) Attitude & Communication Gap

A three - way gap between the Government, financial intermediaries, and the borrowers.

(IV) Historical and Policy Gap

The historical development of the financial institutions, the newness of industrialization and the under - developed nature of the country, the development policies of successive governments, i. e. absence of continuity (of policy) and ambiguity of policy.

(V) Structural Gap

The structural inadequacy of institutions and the stock market, the short - comings in the management and the financial structure of the firms and the organisational structures of the institutions coupled with the backwash of structural limitations of the whole economy.

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(VI) Qualification Gap

The peculiar difficulties the lenders and borrowers face. In the first category, are the degree of risk associated with small firms and new ventures, legal obstacles, and costs in lending. In the second category, are the problems of meeting loan requirements.

It is not the purpose of this paper to elaborate these deficiencies, but to examine likely solutions to ease the burden to some extent of the small and medium scale industrial sector. No attempt is made to recommend solutions, as this is outside the purview of this study; this paper only outlines basic guidelines on the direction of change.

In doing so it has to be kept in mind that the problem of finance, dealt with in this study, is not alone the unavailability of adequate access to credit or the mere shortage of financial intermediaries, but it is the outcome of many obstacles summarized above. Further. who, or what, contributed to the problem, cannot be laid at the door of the successive Governments, the financial intermediaries or the industrial sector, but each have contributed to the problem together with the interlinking pressures of the economy and the historical development of the country. Therefore, the plan of this paper is to outline what each, i. e. the Government, Financial Intermediaries and the Industrial Sector, could contribute to ease the burdens.

1. **Government,** What is suggested here is a four fold programme by the Government and the successive Governments to come, to create the infrastructure for the healthy growth of industry. This can be broadly divided into—

   (i) Political (ii) Financial (iii) Incentives (iv) Services.

2. **Financial Intermediaries**...
3. **Industrial Sector.**

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(I) (i) Political

The varying interactions of political ideologies since independence have resulted in the haphazard growth of industry, mainly as a result of lack of continuity and non - implementation of plans. However, during the last decade there has been a polarisation of policy objectives towards industry and agriculture , of the two major political parties that have formed the Government since independence. Since development in all spheres and a prosperous country is the objective of all political parties, a concerted effort is called for to assist the promotion and development of industry and agriculture. It has to be appreciated that a period of five years is not adequate for the success of any industrial unit or for the implementation of any industrial policy. Therefore, if there is a general understanding among all political parties, of the need for a common and continuous programme, resulting in a development policy once embarked upon and implemented, which is continued notwithstanding what party forms the Government, the cause of the basic disequilibrium in the industrial sector could be eliminated. The resulting guarantee of continuity of policy measures would increase the stability of investment, optimism in the financial and investment market, and the growth of confidence in the lenders and borrowers alike. This would give time for maturity of industrial programmes, lessen the industrial chaos that has been the hallmark of industrialisation in Sri Lanka and cut down waste, in human, material and financial resources. This would contribute to the growth of real economy. By real economy, it is meant here, not mere saving, stinting, and doing without, as has been the case so far, but it means the prevention of waste, conservation of all valuable energies and materials, and the abolition of muddle.

Having laid this basic foundation which upto now has been deficient, it is opportune to plan the strategy of industrial development.

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A basic assumption made in this paper is that small industrial units have a very important role to play in the industrial development of the country. It would suffice here to stress it in the words of Staley.

> "Modern manufacturing industry is one of the requisites for attainment of the economic, social and political goals of developing countries-along with progress in other important fields like agriculture and education. A country usually needs to develop a nucleus of large factories in carefully chosen lines and also many smaller (but modern) factories, likewise in carefully chosen lines. Its industrialisation programme will then be more solid, better balanced and more effective in meeting the needs of the people for manufactured goods, and for employment, than if promotional efforts were to be concentrated exclusively on very large industrial projects or on small industry alone".[1]

Presuming that all are in general agreement that for every industrial giant, there are many much smaller units which also play their part in the economic life of the community, a basic decision has to be taken in the demarcation of industry into sectors in terms of size. This is very essential for administrative and policy purposes, as otherwise the usual tendency is for all industry to be 'lumped' together, and any measures, be they incentives, financial or fiscal measures, or services, become ambiguous in relation to the small unit. When this is the case the result has always been that the small and medium sized firms have not benefitted from any incentives or services, while they have suffered most from any restrictive measures introduced.

Having established some form of size demarcation, it has to be followed by a survey of all present industries both large and small,

1. Staley E and R. Morse 'Modern Small Industry for developing countries N. Y. McGraw Hll 1965.

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parallel to a survey of all raw-material and man-power resources, a survey of all financial institutions and intermediaries, various ancillary agencies, Government Departments and all other bodies presently dealing with industry. The results of these studies are expected to bring out the limitations, shortages, scarcities, misdirection, duplication, and the present situation and interlinkages of the industrial sector as a whole. Once this is achieved the immediate needs and those of the future, of the industrial sector in relation to the development of other sectors, would become clear.

Finally apart from demarcation of industry into size, it is important to identify at the outset what small industry is. A common mistake is that small industry has been often indentified with handicraft and cottage industries. Developing cottage crafts alone is no ultimate solution to industrial expansion due to a number of limitations, such as marketability, quality, uniformity, continuous supply, employment and application of modern methods. Therefore, fostering of ancient skills and crafts have more of a social and cultural than an economic value. This is not a plea, to discontinue help to all these traditional crafts, for in some cases, good commercial linkages could be forged with modern manufacturing industry,[1] but to observe that helping small industry does not begin and end with fostering of cottage industry.

1. (ii) Financial

Once the prospects of continuity, recognition, size, and stability are achieved it is relevant in this study to limit the possible solutions for improvement of the financial accessibility of small and medium sized firms. This has to be tackled first with an investigation

1. A few examples of such linkages are those between crafts such as pottery, mat and basket weaving with modern industrial units such as interior lighting and decoration, and luxury packing.

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similar to the Bolton Committee in the United Kingdom, on the existing financial sources, their present direction, limitations and deficiencies, in the provision of financial facilities to the needy small and medium sized firms in the country.

It has to be kept in mind that development financing of industry has many facets, such as :

(1) the financing of new industries, their need for equity finance, short and long term needs;

(2) financing of existing industries, their short and long term needs, such as expansion of capacity, output, diversification, equipment financing either outright purchase or hire purchase or leasing finance; and

(3) venture and risk capital needs which have entirely different characteristics than those of normal needs, for example, financing of research and innovation.

Therefore, a programme with a general purpose set up with just a broad objective of financing small firms would immediately run into difficulties, if adequate emphasis is not placed on the provision of finance for different aspects and needs of the firm. A mistake very often made is the assumption that financing of industry is very similar to provision of finance for any other purpose in the economy such as agriculture and commerce.

Another erroneous assumption that is made, is that any person who is a good administrator is capable of administrating financial services. This was the main failure of the abortive attempt at 'financing the small firms programme' of 1962. For, in this case the administrative offices in the various districts were given the responsibility to assess the creditworthiness of the clients. The fact that the applicants were deemed honest men and were able to provide some sort of guarantee or security were the two criteria

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most often used, while factors such as feasibility features, comparative advantage, inter-linkage, availability of factors of production, income generation, profitability, growth prospects, marketability of products, experience and ability, were given scant attention. It has to be kept, in mind always that development financing is more complex than the criterion of providing finance merely to earn a profit. This study from the experience gained in its survey of the small firm sector is however pessimistic about the success of adding more financial schemes, without first studying the overall financial structure in the country.

This limited study here, has found that the existing institutions cannot cope with the needs of this sector, especially in the field of new industrial ventures, provision of risk capital for innovation, and the provision of long term capital for expansion and development. It was also found that at present there are no long term credit institutions directing their activities to this sector. In relation to the size of the country, and in physical numbers perhaps, there are adequate number of institutions, but the point at issue is, that most of them have over the years deviated from their original intentions for their establishment. While others, as they are presently constituted, cannot be functional, due to the special problems of development financing, especially of the small firms. Therefore, what is suggested here, is not a mere proliferation of financial institutions, but a restructuring of the present institutions. At present there is a process of restructuring that has been contemplated, but even in this proposed structure the case for an institution or a subsidiary of an institution to provide finance to the small sector is absent. As Davenport remarks, 'Goverments in both developed and developing countries have concluded that the financial needs of small enterprises are sufficiently distinct and urgent and inadequately served to require special financial facilities,' but this does not seem to be the case in Sri Lanka.

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In summarising the present structure here, the commercial banks, keeping in mind their development and structure, cannot, even with reorganisation be made to fulfil all the financial needs of the small and medium scale sector. At best considering their present activities, the banks could be made to fulfil the short term and to some extent the medium term needs of this sector. This still leaves the most important needs unfulfilled, namely, long term capital.

This leaves the field open to two alternatives, i. e. either the setting up of an entirely new organisation or restructuring an existing one and attaching to it this role of provision of long term finance to small industry. This study is not in favour of the first alternative, due to a number of reasons. The foremost among them are, the inadequacy of trained staff and administrators to entirely staff a new organisation, limitation of funds, and the limitation to spread risks of such an institution. In the case of the second alternative, there is already an institution that has so far kept its head above small firm financing, i. e. the DFCC, despite the fact that its sponsors envisaged that a creation of such an institution was in the main, for this purpose. For the IBRD mission,[1] who recommended the establishment of a development bank, envisaged that the country at the beginning should embark on small industry. 'Our conclusion is that for the present, Ceylon's main industrial growth should be centered on the development of numerous small and medium sized industries, rather than a few large ones. These should be widely scattered and diversified, to take advantage of labour and raw materials in various parts of the island.' It is apparent therefore, that along with this recommendation, when they suggested a parallel institution to provide finance, what they had in mind was an institution to provide financial services to

1. The IBRD Mission of 1952. see the Economic Development of Ceylon Vol. 1, IBRD Washington Hopkins 1952. Page 43.

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those industrial units that could not find long term finance elsewhere, implying that they really had the small and medium sized firms in mind. However, since its establishment, it has avoided the task of small firm financing altogether.

What is suggested here is, first an expansion of its scope of lending and other services, with perhaps separate divisions concentrating on different size sectors of industry. To begin with, expansion could take the form of lowering the 'minimum sum' loan scale that stands today at Rupees 100,000, at least by half, to Rs. 50,000. It is interesting to note that even the ICFC of the United Kingdom has a minimum lending limitation lower than the DFCC.

Expansion also involves greater access to funds both local and foreign, by the institution, for disposal. There is not, much of a problem about foreign funds as they have access to IBRD funds and the likelihood of obtaining funds from other foreign institutions. Some time ago it returned the second line of credit made available to it by the IBRD, gaving the reason that there were not enough credit-worthy clients. As regards domestic funds, the shareholding of banks both local and foreign could be increased with also the likelihood of contribution to funds from the savings institutions and long term fund depositories [1] Further there is nothing to prevent the DFCC floating its own development debentures.

At present, there are a certain number of private shareholders, of which some are private industrial units. They should be made to sell their shares to credit and savings institutions. The reason being that it is unethical for an organisation, which lends to business and industry (mainly from Public funds, i. e., Government loans, Central Bank loans, Bank of Ceylon loans and the IBRD loans

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1. e. g. Employees Provident Funds, Insurance Corporation, Savings Bank etc.

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fully guaranteed by the Government), to have shareholders from the very sector it lends to.

Experience in other countries has shown that businesses, for their own interests, have bought over controlling shares or have high investments in financial organizations with the intention of influencing its credit policy favourably towards themselves or their colleagues and also to prevent loans from being disbursed to their competitors. There could also arise the possibility that when private shareholders are involved that it would stray from the objectives of its establishment namely, to be a development institution in the correct sense of the word. When security, safety and profitability objectives of shareholders become the over-riding objective there is a tendency for the organisation to become conservative, with its direction merely to make a profit. In fact there is evidence of this happening to the DFCC, where, as mentioned earlier it has exempted itself from small firm financing and most other original objectives and has concentrated on financing large firms which are predominantly taken to be 'safe'.

The concentration of the direction of its activities, predominantly as a profit making body, involving itself with loans only with a high degree of profitability and safety is also supported by its recent statement when they returned the second line of credit made available to them by the IBRD with the following observation namely that 'DFCC's ultimate obligations are to the shareholders and it is imprudent to invest in projects which may or may not result in a fair return on the investment'. Such a viewpoint, this study considers as a very conservative statement for the only development bank in the country to

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make, and all the more objectionable when the oblications they speak of to shareholders whose liability is limited, have shares of only Rs. 8 million.

It is important to digress here, from the main subject, and mention the objectives of the ICFC in Britain. The ICFC, in its loan policy admits that most small loans show no profit at all on a strict allocation of expenses, as the cost of investigation, negotiation, and administrative costs do not decrease as the size of loan decreases and on a correct provision of risk capital. However, the ICFC undertakes certain investments to encourage new developments within its field, where the risk is impossible to assess with the accuracy required for a strictly commercial investment, or terms which do not offer a reward corresponding to the risks, even if the venture is successful.

"Loans of £5,000, £10,000 or £15,000 cannot pay us, but they are part of our business and we do as many as we can...... It is the feeling that if there is a need for money which they cannot raise conveniently elsewhere, and there is a case for them having the money, then we ought to provide it" (as stated in an interview by the first Chairman of the ICFC, the late Lord Piercy).

From what has been said above, this study in no way desires the DFCC to become a philanthropic institution, and accommodate whoever requires credit, but it is a case of not having their development priorities right. In this regard it is apt to quote the principles and activities of the Canadian Development Bank from which the DFCC, could well borrow a few examples.

Section 15 of the Industrial Development Bank Act empowers the bank to extend credit to any industrial enterprise in Canada

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provided that such credit would not otherwise be available on reasonable terms and conditions, and provided also that the character of the investment and the amount invested by others are such as to afford the Bank reasonable protection. The Bank interprets this section of the Act to mean that it should go as far as it can to meet applications for financial assistance which appear to satisfy the foregoing requirements, No approach to the Bank is declined on the grounds that the effort required to investigate it and reach a decision would be disproportionate to the financial return which might be earned on it by the Bank. The Bank is prepared to give just as much attention to small loans and to borderline proposals as to larger requests which would provide a greater financial return to the Bank. It is not unusual for an application to the IDB for (say) a $15,000 loan to receive considerably more effort and time than one for (say) $100,000. [1]

Apart from reorganisation of the present institutional structure as suggested above, there are also additional steps which the Government could take to increase the fund availability to this sector, Some of which are relevant, are given below.

(a) As mentioned above, following the principles of the Industrial Development Bank of Canada, the DFCC should be persuaded to refrain from giving accommodation to those large firms which could well afford to go public. This would not only provide greater funds to the small and medium firm sector but would activate the stock market.

(b) At present the Government siphons off the major proportion of the funds from the savings institutions and the long term fund depositories. There could be an arrangement by which

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1. Extract from the submission by the IDB of Canada to the Royal Commission on Banking and Finance. Oct. 3, 1962.

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at least some of these funds are reserved for investment in the industrial sector, either by a method of direct Government loans through the medium of the commercial banks, or through lending to a long term credit institution like a restructured DFCC. The need to follow such a course of action is accentuated by the fact that private investors, especially the small investor, are both unwilling to come to the market; and invest in private companies. As these savings deposits and other compulsory and quasi - compulsory deposits are made up of funds of the public, this is an indirect method to encourage greater savings, as by such a course, these institutions could be able to offer higher interest rates to the depositors. The loss of sources of funds for the Government could be taken care of, by a greater effort to harness unproductive and hoarded funds, firstly, by uplifting the activities of the savings movement, and national savings bonds, greater fiscal controls on unproductive fund usage, a scheme of activity such as Premium Bonds in Britain, and duplicating the very successful lotteries system.

(c) An alternative or parallel to this arrangement is the issue of development debentures backed by a Government guarantee with higher interest rates than those presently given on Government securities, which in turn is siphoned off to Banks and other lending institutions.

(d) Setting up an Investment Trust to harness small savings.

(e) Another urgent need in the country is a Credit Guarantees Corporation. A case was made for such a guarantee scheme by the Bank of Ceylon Commission in 1968. The form, and method of such an institution has to be worked out with the cooperation of all those institutions that are presently concerned with the financing of industry, agriculture and commerce. Whatever forms it takes, there have to be checks so that a

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programme of this nature would not stimulate indiscriminate financing of enterprise.

(f) There is also a case for differential rates of interest to be charged on different types of lending for development purposes. It has been said, that there is a differential in the marginal cost of lending and risks between large and small loans. Therefore, according to economic price theory, higher marginal costs of lending and risk should be reflected in higher interest rates. The cost to the borrower of higher lending rates could be alleviated to some extent by a credit guarantees programme and secondly, by a system of rebates. The latter could operate, when the lenders consider that there is an additional risk in some types of accommodation. When this is the case, an additional risk margin of interest could be charged by the lender which is refundable if the borrower honours his commitment at due dates.

(g) Funding Banks and other institutions: At present, banks lend only residual funds to small firms after their favoured and regular clients are served. During certain periods this residual is small or nonexistent. The Central Bank directs banks to lend for development purposes, but the term 'development' is rather ambiguous for checks to be set in, to assertain that these funds really go for development purposes and to really deserving enterprises. Therefore, there should be specific directives like, those that persently exist for tea factory development, for small industry as well. A portion of Central Bank funds that is lent to banks, could also carry the directive that it should be lent only to small and medium size industry.

(h) Supplier Credit for equipment: If equipment such as machinery and even raw materials are imported by an authorized body who could resell it on an instalment or hire purchase terms, it could first cut down heavy financial commitments of firms at one time, while it would also eliminate, the present dodges practiced by some

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firms, such as overinvoicing of imports, and keeping a certain margin of their funds abroad. This would also help to cut down the monopoly of sellers and help the process of standardization of equipment. However, care should be taken that the usual Government bureaucratic practices do not enter the administration of such an organisation, as this would jeopardize the efficiency of such an institution. Illiquidity of small firms is also due to a lack of raw materials, in many instances, small firms are forced to buy their raw material requirements from the 'black market'. State Corporations have been given priority in, raw materials imports, hence there should be a policy, that deserving units irrespective of their size should have equal access to raw materials.

1. (iii) **Incentives**:

Incentives can take many forms. The foremost among them, is assurance of continuity of policy measures. This could be achieved by adopting the political measures described earlier. Continuity, naturally brings along with it security and certainty of the future. These are the key factors that have been absent upto now, since the commencement of industrialization in the country. Industry, and for that matter any enterprise, cannot manage their units by 'fits and starts' based on the ever changing policy of Governments. Planning processes need a number of years to develop and an assurance of continuity for forward planning and investment decisions. Once policy and incentives are made known, the Government must fulfil them, as otherwise, apart from the disruption caused, another important criteria for growth would be lacking, namely, trust and lack of faith in Government policies, assurances an incentives. Finally, policy when laid down should be clear and unambiguous, so that, on the one hand little is left to the discretion of minor officials and on the other hand the prospective entrepreneur knows precisely the type of assistance that is available.

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Recently some new measures have been proposed by an Ad-hoc Committee appointed by the Minister of Industries to consider what fiscal incentives should be given to industry, one of them is of special concern to the small and medium sized firms. The recommendation was that, apart from foreign earnings released to registered exporters on special applications, registered exporters be granted a percentage of their FOB earnings in foreign exchange. The Committee further suggested that such exchange be utilised for authorised purposes, including travel abroad, advertising abroad, export promotion work, participation in exhibitions, fairs and seminars and export marketing purposes.

If this scheme is to be successful, there is a case for a clear and precise definition of, who the real beneficiaries would be, and what precisely should be done with the accrued benefits. In other words ambiguity has to be avoided, and the term 'registered exporters' has to be defined. For, in the case of the FEEC scheme,[1] at first, registered exporters were erroneously presumed to be the middlemen who exported the final goods and not the manufacturers and producers themselves, resulting in the benefits of the FEECs accruing to the middlemen whose only contribution was the shipping of the goods. Many of the middlemen refrained from passing these benefits to the manufacturer. In the case of manufacturers who are themselves the exporters the problem would not arise, but in the case of small firms who do not have the capacity to export their goods themselves, the benefits would be siphoned off by the middlemen unless adequate checks and balances are introduced.

1. This was a scheme with similar aims which was introduced in 1968 chiefly for the encouragement of non-traditional exports. Under this scheme all exports other than those deemed traditional received Foreign exchange entitlement certificates (FEEC's) equal in face value to the FOB value of foreign exchange actually earned by such exports. The receipients could utilize the certificates for import of goods or sell the certificates as they were freely transferable.

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This benefit proposed is to increase the export potential of non-traditional goods, produced mostly by small and medium sized firms, thereby increasing the foreign exchange earnings of the country. However, the net gain under any scheme, such as that proposed above, the FEEC scheme, or Export Bonus Voucher Scheme, or any other scheme where part of the foreign exchange earned is passed on to the exporter/manufacturer, depends upon the import content of the input goods in the final export goods. The higher the import content of the inputs, the lower will be the net foreign exchange gain. Therefore considerable caution has to be exercised when applying a scheme of this nature to exports of products of industries, whose import content is very high. For, if the benefit is calculated on the gross FOB value, it may result in a growth of an artificial re-export trade for the purpose of merely cashing in on the benefits.

Most fiscal incentives have had a tendency to be ambiguous, this has naturally resulted in, (*a*) the small and medium sized firms being overlooked and (*b*) the 'pseudo industrialist', qualifying for them. The overall outcome has been a misutilization of these incentives, resulting in the creation of attitudes by the Government which is detrimental especially to the small firm. It would suffice here to ricapitulate a few key factors that went wrong, in the Five Year tax holiday.

(*a*) The absence of proper size demarcation of industry: tax incentives were given to those firms with over twenty five employees. This left out all small industry in the country. Most small firms started business with their own personal capital and family savings, the total of which was small. Therefore from this statement it follows, that the new units which were set up, began with small workforces inclusive of management. The survey[1]

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1. See footnote on page 45.

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findings confirmed that seventy eight percent of the firms had a workforce of under twenty five employees at the time of their initial establishment.

(b) As it worked out, the tax holiday did not really bring the results it was expected to do, i. e. reinvestment of profits. The reason was that the system was self-defeating as a result of profits as well as dividends being exempt from tax for five years. This added to the uncertainty of the future that has always been a factor prevalent in business circles, made those who qualified for this incentive, take the shortest and what they deemed the wisest route out, following the maxim, 'make hay while the sun shines'. The result was that, not much of the profits were reinvested into the business but were taken away as dividends, much of which appear to have been spent on conspicuous consumption purposes, such as the purchase of luxury cars, building of luxury houses with luxury furniture and fittings, hoarding in the form of gold and jewellery, expensive social functions and even the conversion of part of it into foreign exchange in the 'blackmarket'.

In this regard it is interesting to note that in Britain during the post war reconstruction period between 1945 to 1950, when the Government as part of its economic policy introduced tax incentives, there was an accompanying limitation on dividend disbursement by those qualifying for the incentives, i. e. for many years the profits tax discriminated powerfully between distributed profit and undistributed profit in favour of the latter. Thus the introduction of a disincentive tax on dividend disbursement should be a natural outcome of any profit tax incentive, not only to guarantee that profits are reinvested, but that they are reinvested wisely.

Another incentive in the light of difficulties mentioned earlier is to restructure the legal system, as far as it affects the

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industrial sector and industrial lending. This would be a boon to both the lenders and the industrialists alike, especially the small entrepreneur, as time, intricate legal procedure and costs could be pared to a minimum. Another measure that would help to increase the profitability of small firms, is the likelihood of the Government assuring them of a better market for their goods, such as giving them Government contracts, and ensuring that the state industries use some of their products as inputs in their production.

There have also been other Government policies which have affected the small firms adversely. For example, fiscal measures such has increase in duties, decrease in quotas, and import ban of certain raw materials, have created problems in this sector. It is not the measures themselves that are at issue here, most of which were necessary due to the scarcity of foreign exchange at various times, but that they come too suddenly and without prior warning, which takes even the best managed firm unawares. Therefore, it is for the good of all, that there should be clear advance warning of any such new changes, as then, the industrialists could plan ahead to either find more funds to meet the impending increase in duties, or alter their production processes to work within the impending decrease in raw materials, so that the disruption of the production process is minimised. There is also a good case for advance consultation, at blue print stage of all those who will be affected by any new policy change, and for implementation to take place with a 'time gap' depending on the circumstances. The latter would not only give time for those affected to prepare themselves, but also would show in advance deficiencies that may arise.

Even in the case of Government incentives, there have been cases where the absence of forethought had seriously affected the small and medium sized firms. Two examples are, (i) the five

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year tax holiday, and (ii) the result of the introduction of the FEEC scheme, on small firms (mentioned earlier). The former placed the small firm at a serious disadvantage, against their competitors who had the financial capacity to start the firm with greater factor inputs (over 25 employees) thereby qualifying for the tax holiday. Both these measures, although they were incentives, seriously affected the small firm, and weakened their competitive position against the larger firms. This further pushed them back in the 'queue' for accommodation from the financial institutions.

The Government has introduced income ceilings on the accumulation of capital in private hands, and a compulsory savings scheme, where a certain percentage of one's income is compulsory acquired by the State. In the case of the former it has two serious effects on the economy as a whole which indirectly affect the small firm. Firstly, the prospect of a ceiling on income necessarily cuts down savings, some of which could have been harnessed as a source of funds to industry. It was mentioned earlier, that those large firms who stlll turn to credit institutions for their long term fund needs, could be persuaded to go public to acquire their funds, but an income ceiling would retard private capital accumulation and thereby lessen the number of private investors who could enter the share market, and the stock market would stagnate further. This will further discourage firms from going public and act as a deterant to those institutions underwriting stock issues, due to absence of buyers. The result would be, that large firms even more than before, will have to turn to institutional finance, and as has been the case before, given the choice it is natural for the institutions to accommodate established large firms in preference to small firms. Secondly, this income ceiling necessarily cuts down incentive for enterprise, resulting once again in less capital accumulation and therefore,

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even the little capital that flowed into small and medium firms from private sources is lessened further, and the prospects of increasing this flow in the future is jeopordised.

In the case of the latter, i. e., compulsory savings, perhaps the welfare aspects of the scheme cannot be faulted with, but once again a certain amount of funds in private hands is lessened, thereby indirectly increasing the financial vulnerability of entrepreneurs and the necessity to turn more often to outside finance. It may be said that the observation above, is a narrow analysis based on the view point of a sub-sector of the economy, but even in the case of enlarging it to encompass the whole economy, the results will be the same. The reasons for this view are not discussed here, as they would deviate from the subject under review in this study.

1 (IV) Services

It was mentioned earlier, that the mere provision of more financial avenues alone would not solve the problems of small and medium firms, but that this is only part of the solution, while the balance is the provision of services. This is a very vital link in the solution, to ease the difficulties of financial accommodation, not only of the borrowers, but the difficulties the lenders, face as well. Further it would also aid Government planning and control of this sector, with minimum waste and maximum efficiency.

The services would consist of direct services, such as facilitating the availability of machinery, raw materials and spare parts, guarantee of fair prices, marketing, transport, factory facilities, and indirect services, such as counseling, advisory bodies, training facilities and monitoring services.

The most profitable method to evaluate the types of services needed would be by a series of surveys. The important points to be

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established are, (i) to examine the present situation of the firms, their needs and prospects and to establish the type of special assistance they require, (ii) to examine the presently available services and the facilities that they provide, the degree of overlap if any, and the deficiencies.

As the type of direct services described above are self-explanatory, emphasis is placed here on the indirect services. Once the basic requirements are found from the type of overall surveys mentioned above, the need would arise for specific surveys on each problem identified. Specific surveys are many faceted, and a various types of surveys and their usefulness are mentioned below.

(a) Industrial opportunities based on development priorities: This would show their attractiveness based on raw material and other factor availability. Therefore funds which are a scarce resource could be better utilized from the outset.

(b) Factor Surveys:

(i) Human: This would show human resources available in terms of experience, skills and qualification. It would facilitate to set up training programmes in the skills that are scarce, and show the rate at which local expertise could replace foreign consultants and technicians, in the various industrial units.

(ii) Raw material and captial goods: It would facilitate development of new units, expansion of existing units, and termination of those which are uneconomic, and hence serve no useful purpose. Further, the results that could be achieved, consist of finding new products based on new raw materials, different uses for existing raw materials and waste and forging of correct machine, manpower and raw material mixtures. It would also show well in advance the state of

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existing machinery, the need for imports of spare parts and replacements, and the desirability of manufacturing local machinery and spare parts. All these findings would cut down fund wastage, while at the same time, it would enable the lenders to take an active approach to financing, by making them aware of promising sectors.

(iii) Financial: In the light of this study, this is the most important, as basically "money" is the core of all enterprise. Financial surveys would pinpoint the existing services and their bottlenecks, financial management of firms and their weaknesses. Further surveys would facilitate, (a) the integration of financial measures with other measures to uplift the efficiency of the sectors (b) to understand the problems of both the lender and the borrower as shown in this study, (c) the lenders to understand the development importance of alternative allocations of financing, which is vital, especially in the case of long term loans, (d) the combination of other studies such as on markets, level of competition and other aspects of industry, in which the applicant plans to operate, thereby enabling the institution to appraise the viability, profitability and safety of different classes of loans, (e) encourage better use of entrepreneur funds and indirectly improve the quality of loan applications, and finally, (f) to reveal the levels of finance needed for different enterprise, and whether this need is real, or the finance required is too high or low.

(c) Market Surveys:

This would once again cut down fund usage, by prevention of ill planned and uneconomic ventures and the ills of a perceived market as against the real market, help pricing of pro-

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ducts, quality control, health safeguards, forward planning and fund disbursement of firms.

(d) Monitoring Surveys:

This is one of the most important surveys that should be in continuous use, when an economy is State controlled and planned, as is the case in Sri Lanka. This would help to evaluate the end results of services, facilities and incentives, which would show the prospects for the future, profitability of services in the economic sense, the reasons for success and failures of programmes, and the need for new services.

It is apparent if surveys are to be successful that they should not be too prolonged nor, done with undue haste, as both would result in unsuccessful results. Further there is a case for giving publicity to the surveys very much in advance, so that maximum commitment and interest is generated among all groups who would be the participants. Once surveys are complete and appraisal is made, intelligent implementation of the results should be made within the shortest possible time, as otherwise, the whole exercise would turn out to be a waste of resources in terms of time and money.

Even in the case of a small country like Sri Lanka, the whole burden of all these services cannot be done by one planning body has the tasks and the problems of the economy are too numerous, while on the other hand the division of services and attaching them to Government Departments, result in duplication, a lack of purpose and direction, insufficient stress and weak application. At present, the Ministry of National planning as a standing committee on rationalization of the Industrial sector while various tasks of data collection are done by various Department as and when necessary. The result of putting the industrial sector into one group, has always resulted in the

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problems of the small firm sector being overlooked. One solution is to demarcate the industrial sector by a size measure as proposed earlier, and reconstruct the old IDB into a Small Industries Development Board (SIDB).

The possible structure for such an institution is given below. The administration of this body is to consist of an appointed body of permanent staff together with representatives appointed on a rotational basis from all other bodies that are connected to small industry. The latter group of representatives would consist of:-

(i) the Central Bank, i. e., Economic Research, Exchange Control and Bank supervision Departments.

(ii) Government Ministries and Departments, i. e. Import and Export Control, Inland Revenue, Dept. of Industries, Dept. of Census and Statistics, Dept. of Marketing, Dept. of Town and Country Planning, Ministry of Trade, Ministry of National Planning, Ministry of Labour and Cooperative Wholesale Establishment.

(iii) Financial Institutions, Commercial Banks, Long Term Credit Institutions, Insurance Corporation, other Savings Institutions. Finance Companies and Institute of Accountancy.

(iv) Trade Chambers

(v) Other Research Institutes, e. g. Universities, Ceylon Institute for Scientific and Industrial Research, Rubber Research Institute, Coconut Research Institute, and Tea Research Institute.

(vi) Trade Unions.

The purpose of having such a varied representation is to forge direct and closer links between the various organizations, in order to build up cooperation, sense of involvement, com-

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mitment and awareness, to smoothen the coordination of decisions and to avoid duplication of effort and services.

The function of the SIDB should be separate from the actual financing of projects. This is advocated due to a number of reasons. For, an organization of this nature should have a friendly and sympathetic orientation towards the need of the small and medium firm sector. Therefore, at first there ought to be a considerable degree of goodwill building between the organisation and this sector in terms of trust, faith and respect and gradually develop itself as a confessor, advisor and counseller. It is only when this is achieved, it could more effectively play the role of a service organisation, with the goodwill necessary for the achievement of two-way communication.

If on the other hand, this institution was responsible for lending to this sector, it might not be able to penetrate the defence shields of the industrialists, nor achieve the amount of goodwill and the degree of impartiality that is necessary because of the following reasons:

(a) A financial institution in granting or refusing loans has to keep themselves necessarily on a formal though friendly basis.

(b) A lending institution cannot always please every applicant. Therefore, decisions taken on reducing, withdrawing, and refusing loans involve painful decisions, which most often antagonises the borrower.

(c) It does not facilitate the process of balanced decision making.

(d) The danger arises of a lender cum counsellor getting too involved with management decisions to protect their investment, and then, being blamed for wrong management decisions resulting in the refusal or inability of the borrower to pay back the capital borrowed.

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Therefore it is in the best interests of the lender, the policy maker and the borrower, that this institution be a separate entity of its own, being distinctly separate from direct financing, although closely connected with every functional aspect of the firm. If doubts of such an organisation becoming too powerful or autocratic is entertained, and a level of control is necessary, the most appropriate institution that could administer it as a subsidiary, though separate from its normal functions, is the Central Bank of Ceylon. Such a function would not entirely be a new addition to functions of Central Banking in developing countries. For example the Reserve Bank of India concerns itself to a considerable extent and in fact occupies a key role, in the development programme of small industries.

The activities of the proposed SIDB can be broadly divided into three main functions, (*a*) Information gathering, (*b*) Analysis, Assessment and Appraisal, and (*c*) Dissemination.[1]

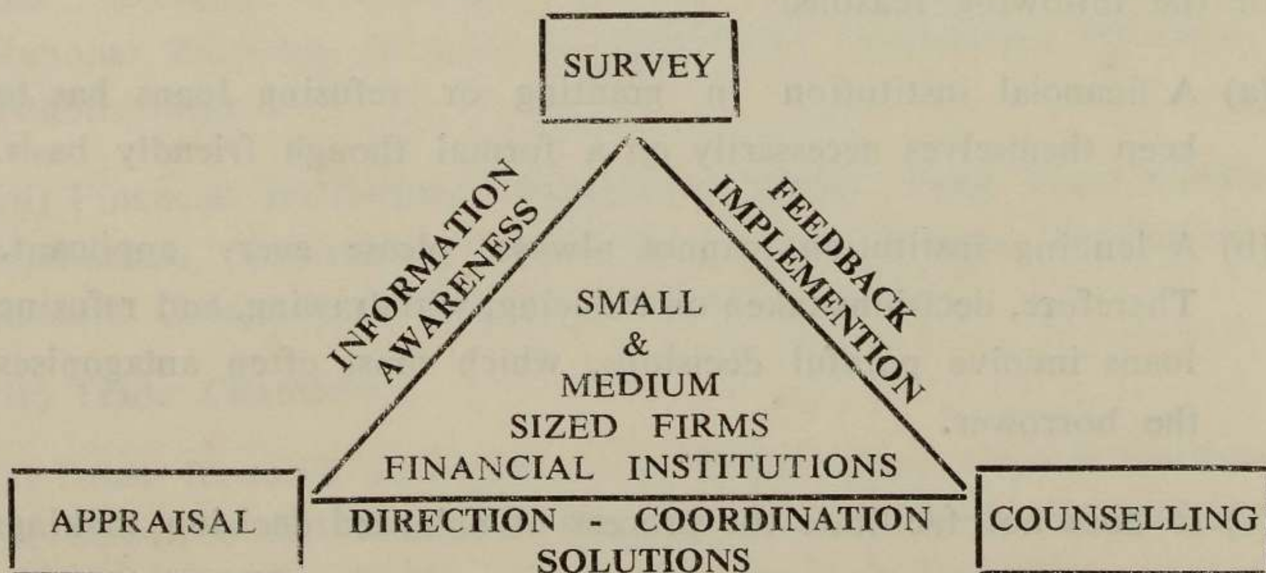

DIAGRAM 1.

In setting up such an institution, two major pitfalls that are to be avoided are:—

1. See Diagram 2.

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(a) it should be independent from, (i) direct Agencies or Departments of the Government, though responsible to the State Assembly through the appropriate Minister, (ii) bureaucratic Government regulations and unnecessary political intervention which would sap the energy and the dynamism, of such an organisation. However it should work closely with the development objectives and priorities of the country.

(b) staffing is one of the most important criteria for its success. An Organisation with such responsibilities and activities should be staffed with people , with experience, achievement, qualification and capability, and with a sense of purpose and commitment.

2. **Financial Institutions**

As mentioned earlier this study is of the opinion that mere proliferation of institutions is doomed to failure from the beginning. The basic weakness in all financial measures has been a misunderstanding of what industrial finance and development banking embody. Therefore any new institution created, would go the same way as the earlier institutions like the AICC and the DFCC, namely, to carve a 'safe niche' in the credit structure and be satisfied with occasional and feeble attempts at financing the small and medium firm sector.

Before considering the possible future prospects, it would be pertinent here to delve briefly on the principal aspects of development banking. In the context of this study, the description which follows concentrates only on the development banking aspects of industry. In this context, their activities would be, (a) provision of long term finance for the establishment of new units which are likely to contribute to the development of the country, and for expansion and modernization of existing industry which

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SOME OF THE LIKELY ACTIVITIES OF THE PROPOSED S. I. D. B.

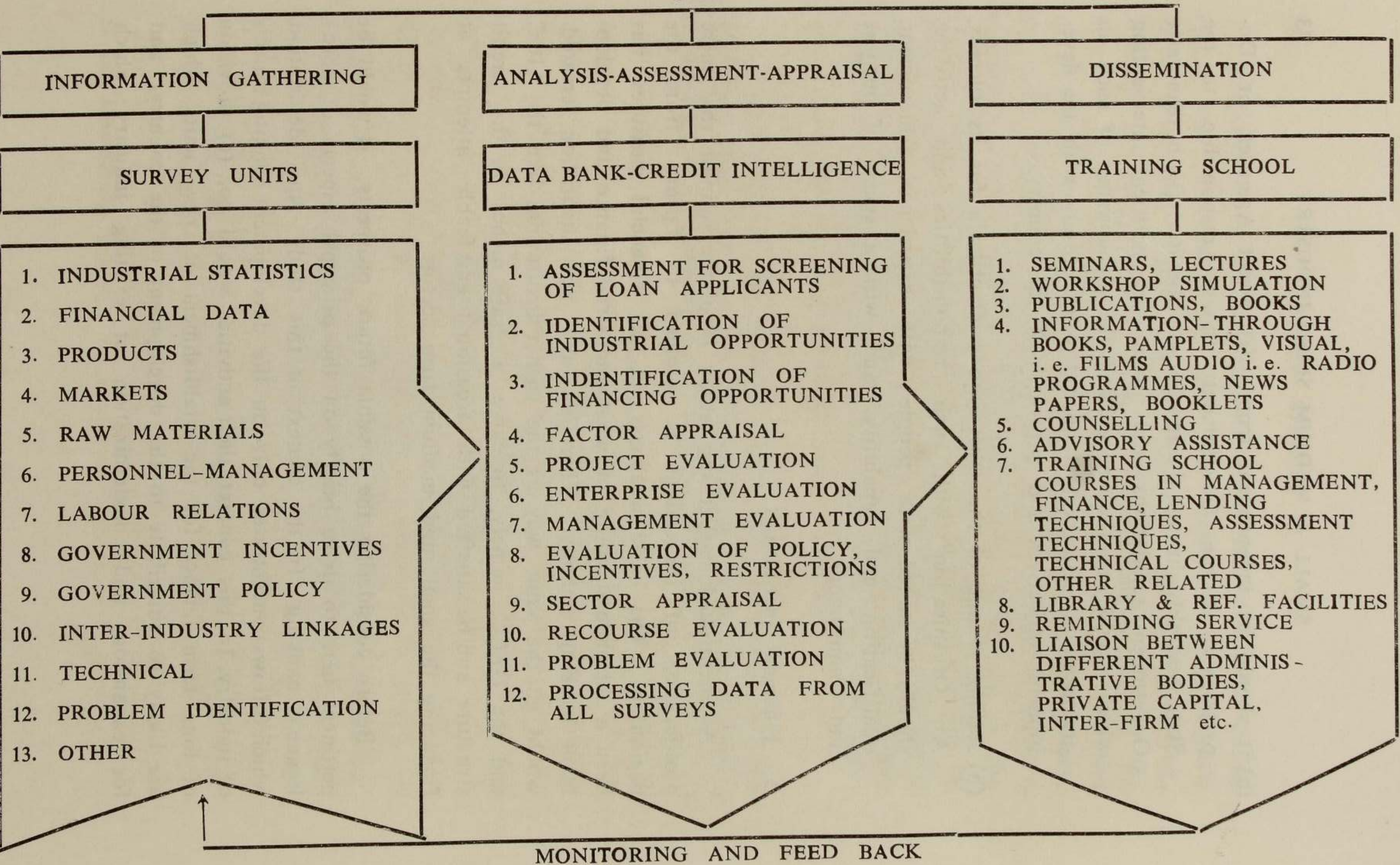

DIAGRAM 2.

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have already demonstrated their growth potential, (b) enterprise participation, i. e. participation in management, supervision, control, counselling, seeking and identification of firms that need financial aid. These two clauses make it possible to differentiate between traditional lenders, i. e. Commercial Banks and Development Banks. In the case of development banking, it calls for a greater degree of involvement of the lender in the activities of the borrower and extends beyond the mere provision of financial facilities, for example, sometimes temporary participation in management, or at least commitment to the cause of industrialisation by active provision of counselling services and aid.

The degree of involvement and the purposes for which funds are borrowed necessitates that the lender should base his judgement on providing accommodation and other services, not only on the accompanying guarantees that lenders are prepared to give for facilities provided, but on the need for funds, the best method for use of such funds, the likely results arising from use of such funds and the prospects of such lending, advancing the cause of general economic growth. To be able to fulfil these requirements, the management and staff of the bank, besides being trained in the techniques of development lending should have advance knowledge of industry and the interlinkage of specific sectors of industry with the direction of the country's development. Having achieved this degree of knowhow, the lender, prior to allocation of funds would be able to ascertain the right priorities in lending to industry by using the following methods.

(a) Management evaluation, i, e., evaluating the capacity, motivation, and other characteristics of the individuals and firms, responsible for the proposed fund use.

(b) Enterprise evaluation, i. e., identifying those who need help, forecasting success, earning prospects and repayment

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possibilities, and the importance of the enterprise in the industrial and economic 'mix' of the country.

(c) Project evaluation, i. e., identifying sound projects for development by existing firms and new firms, and encouraging entrepreneurs to venture into new projects.

(d) Recourse evalution, i. e., assessment of the security provided and the safety of the loan.

The world of finance is a hard-headed, calculating and selfish one, and however much lip service is paid that institutions should be more adventurous and sympathetic towards the small borrower, no level headed financier is willing to listen to these pious hopes as long as more safe, and profitable avenues are availabe to them. Therefore the solution seems to be a Government backed but seperate and independent financial organisation of the type found in developed countries, like the Small Business Administration in the United States of America, the Industrial, Commercial and Financial Corporation in Britain, and the Industrial Development Bank in Canada, or those found in Asian countries such as the numerous institutions, in Japan, and the small Industries Service Institute of India, to mention only a few. The structure for such an organisation already exists in the DFCC. The DFCC could be enlarged in its activities as suggested in the previous sections with perhaps two departments both lending to those firms which are too small to go public, one concentrating on firms that are already established, while the other concentrates on new firms.

In proposing the direction of services of DFCC to those firms that are too small to go public, there is no suggestion here for the indiscriminate financing of small firms, regardless of their feasibility, viability, profitability and creditworthiness. In fact extensive financial facilities for the sake of giving assistance really

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does a disservice to the entrepreneur. It is true that due to an umbrella of import restrictions on foreign goods, there has arisen a number of firms which are inefficient, and are doing the cause of industrialisation an injustice. Here, Government intervention is necessary, (i) either to close down some of them completely, and / or, direct others to branch out into more urgent needs of the economy based on factor availability and export markets, and (ii) to embark on a process of amalgamation of others, to break the deadlock of duplicaton, vertical expansion, and waste.

Financial help to such inefficient firms will be wasted, Just as there are a number of inefficient firms, there are equally, a great number of efficient or potentially efficient firms which need finance. These are the firms that need a helping hand. There are likely to be many firms doomed to suffer from financial difficulties, due to cost of capital being higher than their return on investment at the beginning. Equally many firms tend to remain inefficient and small, due to the failure to obtain capital at the correct moment. The accessibility to external funds is strategic in the life cycle of many small units. Good terms and quick accessibility can be the difference between success and stagnation, while high costs and inaccessibility can be the 'death' of many firms.

The problems, present limitations, and attitudes of banks, could be changed by intelligent policy measures. Solutions to most of them are self-explanatory in the limitations themselves. Therefore, with adequate information, education, and intelligent restructuring, part of the funds of the banks could he harnessed to meet the short term and to some extent medium term needs of the firms. There have been moves to harness bank funds for development needs both for agriculture and industry, but there has been no specific movement to direct them to small firms. In organising bank lending to small and medium sized firms, there arises once again the demarcation of size, there is no escape from

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this problem. This has, so far been the proverbial 'fly in the ointment' in all efforts. For when incentives and aid is demarcated to industry, it really goes to those firms that can manage without it, this is more so in the field of finance, as it is always thought safe to lend to well established large enterprises. "A great many financing programmes turn out, on close examination, to be programmes making small loans to borrowers with much larger resources than one would expect from programme objectives"[1].

It is true that a size measure cannot be defined precisely, but for purposes of serving the sector there is no avoidance of this concept. This is especially important when setting up financing programmes for small industries, where the definition of small industry may need to be specifically demarcated. This definition could have different levels, for example, from owner managed enterprises, to those owned and managed by persons who devote a major part of time and resources to them, while excluding small ventures of wealthy persons, and those owned by large enterprise.

There is also a necessity for a basic change in attitude of the whole financial sector towards the small firms. This could only be improved with adequate knowledge of the sector. This is where the proposed SIDB could help, by bringing the lender and the borrower closer together. Some of the facilities it could extend to the lenders are :

(i) information on applicants and their businesses: for often the fear of risks is due to a lack of information.

(ii) Appraising projects: due to limitation of staff Banks cannot give as much attention as they would wish to do, in appraising a loan applicant, nor can they keep adequate data necessary for quick appraisal. Today, appraisal begins

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1. Davenport R. W., Financing the small manufacturer in Developing Countries. N. Y. McGRAW Hill 1967.

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only when a borrower makes an application for a loan, resulting in delay, which is costly to both sides.

(iii) Training Facilities: Training staff on development financing techniques, giving them a greater understanding of industry, its management and objectives. At present training programmes are few, and are too generalized. Training programmes should be geared to specific needs and those that are trained should be able to assume lending responsibilities.

(iv) Sector Appraisal : to give guide lines to the importance of development and financing of different sectors.

(v) Information services : information on markets and level of competition and other aspects of the sector.

(vi) Enterprise selection : Selection of firms which can make the most productive use of financing. This is especially necessary as funds are a limited resource.

The entire responsibility of gathering information cannot be laid at the door of the industrialists or the financial institutions as is done at present. However, it has to be kept in mind, that the prospect of the creation of an organisation providing these facilities does not diminish the urgency for the institutions themselves to develop a certain amount of knowledge of industry. It is obvious that financial institutions should have their own loan officers with specialised knowledge and training and perhaps practical experience, in industrial operations, to assist in loan appraisals and to follow up their loan commitments. It is only by doing so that there could be a basic change in attitude. A change of attitude can only come fromwithin and not due to pressure from out side. The present structure of banks could be harnessed for this process to take place, for, bank offices are spread throughout the country and therefore the bank staff have the opportunities, if

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they so desire, to get to know the industrialists, build up knowledge of industries and other characteristics of small and medium sized industry, in their specific areas.

Greater involvement would automatically lessen many of the barriers to lending. For example, there have been cases where the banks have been hesitant to give relief in cases where they have already lent in the form of an extension of repayment time In some of these cases the actual causes of delay were not the borrowers own making, but due to Government policy. Therefore, if they were ready to look a little further, for the actual rather than perceived reasons for delay, the case of default would not have arisen in the first instance or could have been avoided at minimum loss both to the banks and the Industrialists. Knowledge of firms would increase further the profitability of such lending as time and therefore cost could be pared by eliminating the preliminary 'jousting' that takes place between the two parties, whenever an application for a loan takes place. Therefore, brief and practical are the preliminaries, less time and cost would be involved. This involvement, and the continuous contact with the proposed SIDB, would result in the staff being capable of understanding modern industrial operations with a fair practical knowledge of technology and methods of operations of the average firm, both of which are essential to correct appraisal of the enterprise to be financed, and those that are already financed. Increasing knowledge, apart from contributing to reducing risk and cost, would also increase the development orientation of financing. This would eliminate also a complex, that is prevalent among lenders towards small borrowers, namely the feeling that they are doing a favour by lending to them and making this attitude known to the borrower, and the borrower accepting it as such. Finally the increase in development orientation of financing would also make them seek out prospective clients. For

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example, as Davenport remarks, 'loan officers in the more progressive banks, no longer sit at their desks waiting for customers to come in at their place of business'. From what was mentioned by industrialists interviewed, loan officers in Sri Lanka not only sit at their desks but sometimes they are 'too busy to see small clients'.[1]

At present the hire purchase companies do not extend much credit to industry. A popular fallacy is that private financiers make no contribution to development. Seeing it in a narrow point of view, private financing of consumption during times of credit restraint may be harmful, but if recognition is given that both financiers and borrowers are engaged in productive activities, it may be possible to foster a more productive approach from the private finance and hire purchase companies. Therefore, rather than criticise and suppress them, regulatory measures could be taken to direct a part of their activities to more productive channels. Despite what has been said of the high cost of private finance houses, it has to be admitted that financiers themselves are vulnerable to deceipt by customers. Therefore, the high cost is not alone a result of strong bargaining power, but also a hedge against greater risks, due to (i) likelihood of most customers turning to them only as a last resort, (ii) their lack of knowledge of industry, and the staff to evaluate business finance.

The new institutions if any, that would result from restructuring of the existing ones should be based within the limitations of the economic framework of the country. The recurring feature of all plans namely, the 'ceteris paribus' cliche should be avoided. In developing countries everything does not remain equal nor can there be ideal conditions. It is true that examples could be borrowed from other countries, but in borrowing ideas and institutional structures, adequate caution should be exercised. The

1. See footnote on page 78.

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reason being, that even if the needs to be served seem the same, and the institution dealing with these in another country is successful, it need not necessarily follow, that the identical institution would be successful in the borrower country for reasons such as cultural and social traditions, habits, education, level of commitment, legal structure, level of development, experienced personnel, and a host of other factors which differ from country to country. An attempt to apply a norm to all and every relationship is a basic fallacy, applied not only to industrialization and devlopment banking, but for every aspect of life.

The enlarged DFCC as proposed here, could take steps to expand their activities to suit the different needs of the firm, such as the ICFC has done in Britain, i. e. finance for innovation, venture capital, equity capital, and the medium and long term needs of new and existing firms. Profitability of a loan alone should not be the criteria for lending, for example, the higher cost of lending to small enterprises could be regarded as promotional expenses. In other words a form of 'farming' of small firms, just as one seed of rice, brings forth a sheaf, containing many grains, the profitablity can be seen only on a long term basis. Lending to a large number of small firms also helps to enlarge and diversify their commitments, resulting in a spread of risks and ability to adjust without much disruption in case of default. The validity of this argument can be underlined by the observation of Davenport, who states that it may be in the interest of the lenders, (although they do not always realise it), when according to conventional calculations, expenses are expected to exceed income and where the demand of large clients for funds and staff time fluctuate, little real costs will be incurred by serving additional clients which help to smoothen out demand. This is based on the economic principle of maximum profit where Marginal Cost = Marginal Revenue. When applied to this, if the minimum facilities essential

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to serve a small number of highly profitable customers are not always fully utilised, then additional clients may be profitably served, if they provide a return at least greater than variable costs incurred in extending services to them.

In concluding this section it could be said that the basic criterian for 'success', is a thorough understanding of small and medium sized industry in the country in relation to development goals. This understanding should embody not only knowledge of the owner and product, but the process of manufacturing, management, workforce, interlinkage of finance and the market. It is only then that the institutions could appreciate and assess the general needs and specific needs, i. e. the financial needs that are basic and those that are peripheral. It has been said that actual needs are frequently quite different from commonly voiced needs. This again is prevalent in all forms of activity. It is well illustrated in the field of industrial relations, where, although the declared and immediately perceivable cause of a strike is for higher wages, the real cause or causes could be a juxtaposition of many reasons, such as insecurity, social needs dissatisfaction with work environment and a host of other reasons. The problem of finance is also very similar. For example, on the one hand when a firm requires financial accommodation, it need not necessarily be that they need finance at all or not as much as requested. The survey confirmed that when some small firms complained that they did not have adequate financial facilities for expansion, it was not only inadequacy of institutions or refusal of others to lend, but in some instances it was a result of a number of factors, such as (a) what they had was adequate but ill-utilised, (b) wrong direction and priorities, (c) that they were basically an uneconomic unit although the entrepreneur would not think so, (d) results of Government restrictions, (e) results of other bottlenecks in the economy, (f) results of bad management, (g) lack of education, training, mana-

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gement and financial skills. On the other hand when an institution complained that financing small firms was risky or that they were not sufficient credit-worthy clients, this once again was a result of a mixture of different factors, such as (a) ignorance of industry and industrial financing, and profitable avenues (b) the fear to venture (c) fear to deviate from traditions and known areas (d) satisfaction with present activities and profits, (e) lack of commitment, (f) uncertainty of future, (g) the desire to back a 'winning horse', and finally, (h) suspicion and disinterest in small firms and their owners.

3. Industries

It has been said that small and medium sized firms have been partly responsible for some of the problems of finance they face. It can be broadly generalised that some of their characteristics are the cause of lack of finance, while others are, the effects. It is an accepted fact of nature, that all seeds sown would not produce healthy plants and this would be more so, if the ground has not been properly prepared. This has been the plight of the small firm sector in the country. By such a statement, no attempt is made to exonerate the whole sector from some of the wrongs committed, but to show causal factors behind their characteristics, Some of these could be eliminated by intelligent policy measures, while others, would have to be lessened by a systematic weeding out process, and controls. It has to be accepted that there will always be some 'wolves in sheeps clothing' in any sphere of activity of man. Therefore branding all entrepreneurs as 'guilty till proven innocent' is doing them an injustice.

Among the small and medium sized industrialists there are those, that whatever finance and other services are provided, would not reach the level of maturity, breadth of vision, and expertise, one requires for successful enterprise and most of them

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will be condemned to stagnation and subsequent 'death'. These could be for purposes of identification called the 'stragglers'. The case argued for, in this study, is not the plight of these 'stragglers', but those who are anxious to grow. Among them there are three types, viz. the 'Deviates', 'sleepers' and 'thrusters'. All of them have similar problems and aims but the way they react to them is different. The difficulties they face are twofold, i. e. (i) structural features of smallness, and (ii) the lack of adequate finance and ancillary services. Both result in making them credit risks and costly to finance.

The problem is that although institutional lenders have spelled out over the years, the terms, conditions and controls over which they would lend, the lenders themselves have been greatly surprised that the borrowers cannot come up to, or meet the standards laid down by them. The reasons have been quite obvious for a considerable period of time, although no attempt has been made so far to study them and take action accordingly. The main reason is that, there is quite a measurable gap between the development of the financial institutions, which are a product of devoloped countries directly imported, and the birth of indigenous small and medium sized industry, with the result a synthesis between the two, has upto now, never taken place. This has left a considerable chasm of misunderstanding between the two groups, and whenever the two groups meet, they think on different planes, although they talk the same 'language' of finance. The result is that the lender for example, thinks, 'what do they know about finance', and the industrialists thinks, 'what do they know about industry'. This is the crux of the problem and the measures proposed here, for example, the setting up of the SIDB as a liaison and counselling service could be the medium through which the problems of both groups could be untangled.

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The absence of a liaison, counselling and other service facilities provided by a special body, and the absence of any of these facilities provided by the financial institutions or other Government Departments, have retarded the growth of firms. It is apparent that this has led to many undesirable financial practices and the absence of good internal financial and management discipline by some firms. For example, many firms become sceptical of obtaining outside finance, while others are frightened away and apply only after they have fallen into difficulties, and need funds only to avoid collapse. It is not surprising that many of them do not have accessibility in such circumstances.

The overall result is that quite a number of them have accepted their plight as inevitable and resigned themselves to keep on going by whatever avenues available to them, be they prudent or imprudent, in terms of correct financial management, legal or illegal in terms of the law of the country. These are the 'deviates' referred to above. The next group like the first has resigned themselves and become secretive about their business, and show a reluctance to discuss their problems although they would always complain about their plight. They are uncooperative with each other, as well as with institutions dealing with them, these are the so called 'sleepers'. Finally there is a third group who can be termed the 'thrusters', who have the tendency to take very big risks, are the most cooperative in 'airing' their problems, are ready to argue it out with lenders and seem to have tackled their problems with grit, audacity and perseverance. The different ways these three groups, and the 'stragglers' mentioned earlier, set about getting on with their business, have made the lenders come to the conclusion that small and medium sized firm are risky and costly to finance. Therefore, despite their method of activity being different, all face the same problems, namely, access to finance and other services.

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The problems they face are not devoid of solutions. The structural and situational features of smallness will always be there and have to be accepted as characteristics of smallness. What ought to be done, is to find practicable solutions to make loans to this sector less risky and more profitable. One and perhaps the only method of doing so, is by a process of systematic education on financial and management techniques, as this would not only help them to organize their units more efficiently but also enable them to make use of all other services provided, to their best advantage. In doing so, it would serve no useful purpose if at the outset, an attempt is made to educate them on techniques directly borrowed from developed countries. What is needed at first are simple and lucid intructions on basic techniques, such as:

(i) inter-linkage of finance to the activities of the firm

(ii) how to raise funds to start the venture

(iii) where to seek funds

(iv) how to invest and where to invest funds

(v) the proper uses of funds borrowed for different purposes

(vi) the methods of raising outside capital

(vii) methods of borrowing from banks and other institutions, funds for, equity, innovation, research, working capital, and long term capital.

(viii) how to assess his requirements and identify the purposes for which the finances are needed, length of commitment, and the methods of repayment.

(ix) how to set about the provision of security

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(x) how to keep accounts not only for purposes of income tax, but principally for the purpose of keeping a constant check on the enterprise

(xi) the presentation of loan applications, how and when to judge the future financial needs even before the need becomes apparent

(xii) the art of demostrating the possibility and prospects of a venture

(xiii) the obligations they have towards lenders, when a loan is received

(xiv) technicalities of the legal system as applied to them

(xv) information of credit services and types of finance available, availability of other services

(xvi) information on Government incentives, duties, tariffs, exchange control, credit restraint, etc.

(xvii) information on different types of taxes and how to provide for them

(xviii) information on raw materials and their uses.

(xix) information on markets

(xx) information on how to set about exporting their goods

(xxi) product pricing, packaging and services.

These are only a few measures that are suggested above. Surveys would reveal what other measures and advise is necessary. Once, such a programme of education is set underway, many of the reasons for instability, risk, and cost, which make them non-creditworthy, would diminish. Further, at the same time, Government policy could help to increase their profitability, by

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low cost legal aid, technical services, cheaper direct services to lower their production costs, assigning them Government contracts, hire purchase and leasing facilities, together with the other services provided by the proposed SIDB.

There is a school of opinion which believe that provision of such facilities will not be appreciated by them, and that they would misuse them anyway. This is an erroneous concept based mainly on misunderstanding and disinterest. For example, there has been disinterest among some of those administering services due to a lack of commitment and absence of responsibility for their actions. Further, planning weaknesses, continuous change in policy and experimentation, have also contributed to this misunderstanding. It is also true that controls breed deviations and unproductive practices, resulting in further controls, and as stated earlier there will always be some 'wolves among the sheep'. This has been the outcome of some controls, the ingenuity of man to find alternatives can never be stopped. The danger is that some of these practices are tending to become the norm, this bodes ill not only to the cause of industrialisation but to the development of the country as a whole.

In the final analysis it has to be admitted that when a person or a group of persons venture into business there is already a level of commitment, sense of involvement and participation ending in a desire to be succesful, if these desires were not present they would not have ventured out in the first place. Therefore, provision of better facilities cannot be denied or neglected for the sins and omissions of a few.

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low cost. [illegible] services to [illegible], adopting [illegible], [illegible] and leading [illegible] facilities [illegible] provided by the [illegible] group.

Although in a school of opinion it was believed that provision of such facilities will not be appreciated by others and that they would misuse them anyway. This is an erroneous concept based [illegible] inability to understand and [illegible]. For example, there has been dissension among some of these [illegible] agencies due to a lack of coordination and [illegible] of responsibility for their actions. Further, planning bottlenecks, continuous change in policy and experimentation have also contributed to this misunderstanding. It is also true that controls breed [illegible] and unproductive practices [illegible] controls [illegible] as stated earlier there will always be [illegible] among the [illegible]. This has been the outcome of some controls [illegible] the necessity of [illegible] to find alternatives can never be ignored. The danger is that some of these practices are tending to become the norm, and this bodes ill [illegible] for the course of industrialisation but to the development of the country as a whole.

In the final analysis, it has to be admitted that when a person or a group of persons venture into business there is already a level of commitment, a sense of involvement and perhaps [illegible] a desire to be successful. If these desires were not present they would not have ventured out in the first place. Therefore, provision of better facilities cannot be denied or neglected for the [illegible] and [illegible] of a [illegible].

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The Role and Impact of External Assistance on the Economy of Sri Lanka - 1960 - 1970

B. V. A. ANTHONISZ

(I) The Role of Foreign Economic Assistance

The objective of this study is to assess the contribution made by external assistance to the development and diversification of Sri Lanka's economy during the period 1960—1970.

The basic role of aid is to finance the short-fall between domestic savings and the level of investment compatible with the economy's capacity to absorb capital.

It is reasonable to assume that there is some level of domestic savings which represents the 'maximum effort' of the community in the sense that it is the maximum that can be raised without destroying incentives and reducing output. Given the maximum savings effort, the difference between this and absorptive capacity would represent the volume of foreign aid necessary if capital is not to be a constraint on expansion. An ideal foreign aid policy would therefore try to ensure that the shortfall in domestic savings relative to the economy's absorptive capacity is matched by foreign capital inflows.

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Besides the inadequacy of savings, there is the additional limitation to investment as a result of foreign exchange earnings falling short of outlays on imports. Accordingly, if the foreign exchange gap is the dominant feature in the economy, an increase in domestic savings is not sufficient to ensure that development takes place. It must also be possible to obtain from abroad the goods and services that are complementary to those available at home. In most developing countries, in the initial stages of development in particular, the structure of the economy is so simple that it can produce only a limited range of products when relying solely on domestic sources. In these circumstances, an act of saving by itself, even though it releases resources for investment purposes, may not make available the correct kind of resources. In physical terms a country may be unable to produce the cement, the steel or machinery which go into the various projects required to raise output, although it may be able to make the necessary savings. Unless these savings can be used to purchase goods and services from overseas, no progress can be made. This "two-gap" approach to the problem of capital scarcity is particularly useful as it brings into focus the "savings gap" which represents the overall and quantitative shortage of capital consistent with absorptive capacity and the "trade-gap" which represents the minimum required capital inflow from abroad.

Main Features of Sri Lanka's Economy in the Sixties

The most conspicuous feature of the economy during the decade 1960–70 was the depletion of the country's external assets as a result of the sustained deficits in the current account of the balance of payments. Since 1957, with the exception of 1965, payments on current account have exceeded current receipts. Intially, the main cause of the deficits was the increase in demand caused by inflationary financing of government expenditure. But after the influence of this factor was moderated by payment and import

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controls, unfavourable price trends continued to impair Sri Lanka's payments position and erode her reserves.

The fact that the total of external resources that were available to Sri Lanka were inadequate is underlined by the severity of the payments and import controls that were introduced in the sixties and intensified thereafter. It is, of course, true that the impact of the controls was most felt in the consumer goods category, but the production sectors too have felt their restrictive influence and industrial plant and equipment have had to be worked below their optimum capacity.

Table I gives some indication of the inhibiting effects on industrial expansion as a result of the inadequacy of imported raw materials.

It is apparent from the Table that all industrial categories can increase their output substantially if foreign raw materials are made available. In Section (2) Textiles, Wearing Apparel and Made-up Garments and Section (7) and (8) which includes Machinery, Transport Equipment and Electrical Machinery and Appliances the scope for such expansion is enormous. The Table does not reflect maximum production possibilities as most units could work more than 1 shift. However, even if one shift is taken as the norm, the gap between realised output and what is realisable is substanial.

Despite the 'bottle-neck' on investment imposed by the scarcity of foreign exchange, gross national product increased during the decade 1960—1970. G.N.P. in 1960 was estimated at Rs. 6,288.5 million; in 1970 the corresponding figure was Rs. 9,695.3 million an increase of over 50 per cent. This decade also witnessed the emergence of manufacturing industry. While the initial impetus to industrialisation was given by the protection of the local market by the imposition of controls on imports, its subsequent development and expansion was largely due to its fostership by the state,

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TABLE I

Usage of Imported Raw Materials—Actual usage as a percentage of requirements for production at full capacity

Industrial Catgeory	Value of imported raw materials needed for production at full capacity (one shift) (Rs.) (1)	Value of imported raw materials used (Rs.) (2)	Column (2) as % of Column (1) (3)
Section 1—Food, Beverages and Tobacco	21,474,873	8,750,422	41
Section 2—Textiles, Wearing Apparel and Made up Garments	36,528,910	14,318,275	39
Section 3—Chemical and Chemical Products	20,043,304	12,367,896	62
Section 6—Metal Products	29,376,810	20,338,473	69
Section 7—Machinery and Transport Equipment	37,637,800	8,402,787	22
Section 8—Electrical Machinery, Apparatus and Appliances	93,782,556	15,832,344	17
Section 9—Manufactured Products N.E.S.	9,657,862	2,860,945	30

Source: Based on Ministry of Industries and Scientific Affairs Capacity Utlization Survey 1968–1970.

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It is noteworthy that the value of 'manufacturing' and construction in the period almost doubled, the percentage changes between 1960 and 1970 being 83.4 per cent for the former and 113.0 per cent for the latter. The percentage share of 'manufacturing' and construction in gross domestic product also increased, though not by much. In 1960 its relative share was 16 per cent while in 1970 its relative share had gone up to 18 per cent. The relative share of the primary sector on the other hand has shown a decline. The value of this sector rose by 39.4 per cent in the decade but its share in G. D. P. fell from 38 per cent in 1960 to 34 per cent in 1970. In the light of these figures it is evident that industry and construction have grown at a faster pace than agriculture, though from a smaller base, and that the share of industry in the economy has increased.

It seems almost certain that the performance of the manufacturing sector would have been much better had it not been handicapped by a lack of imported raw material. Some indication of its elasticity of supply in the absence of this constraint may be had from the increase in output that followed the liberalisation of imports in 1968. The percentage increase in the value of manufactures in 1968 over 1967 was 9.7 per cent while the percentage increase in 1969 over 1968 was 9.2 per cent. The corresponding increases for the construction industry was 30.5 per cent and 13.5 per cent. It is also significant that in 1968, the economy recorded a rate of growth of 8.4 per cent the highest for the period.

Any assessment of absorptive capacity for purposes of external assistance in countries like Sri Lanka must therefore be based not only on the ability of the country to make new investments but also on a quantitative measure of the foreign imports necessary to work existing plant and equipment more exhaustively.

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The period 1960-1970 has therefore been one of modest achievement and also one of disappointments. Some development was in fact realised and the first stages of industrialisation were seen, besides, structural and institutional changes were effected and the infra-structure of the economy was expanded. While on the other hand, the economy remained fundamentally agricultural and industry though it expanded did not reach any great proportions. The signs of an economic "take-off" were hardly evident. Attention was also focussed during this period on the imbalance in the economy; stagnation in export earnings, the rising prices of imports and the consequent shortage of foreign exchange which underpinned the necessity to diversify the economy. This realisation and the context in which it was born also pointed to the value of external assistance in the economic development of the country.

(II) External Economic Assistance

External assistance committed during the decade under review totalled Rs. 2,559,129,813. This sum represents the commitments entered into by donors both institutional and otherwise and is inclusive of the various types of aid resources provided. Table II gives details of aid received by source.

The share of the U. S. A., U. K., Germany and 'others' outside the Socialist bloc in total aid pledged was the highest and accounted for 63.0 per cent. The share of the Socialist bloc was 25.0 per cent while assistance from multi-lateral sources was 10.7 per cent of total aid. In the second half of the decade, there was a substantial acceleration in aid pledged and utilised. This was partly due to the more assiduous wooing of aid and partly due to programme assistance made available by some member countries of the International Bank for Reconstruction and Development (IBRD). Programme Aid commenced in 1965, and with it Sri Lanka received substantial commodity assistance for the first time.

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TABLE II

Economic Assistance pledged by source as at 1970*

Source	Volume of Assistance pledged (Rs. Million)	As % of total
U. S. A.	585,241,646	22.9
Canada	119,835,245	4.7
U. K.	294,464,337	11.5
'Other' Western European ...	419,232,456	16.4
Socialist bloc	638,097,367	24.9
Japan	148,809,600	5.8
India	79,364,622	3.1
International Institutions (Multi-lateral sources) ...	274,084,540	10.7
Total ...	2,559,129,813	100.0

Source: Central Bank of Ceylon.

*Excludes Grants received.

Utilisation of Assistance received

The speed at which assistance pledged by donors is utilised generally reflects the capacity of the economy to absorb foreign capital.

Total aid pledged for the decade 1960-1970 was Rs 2,559,129,813. Of this sum Rs 1,682,060,329 or 65.7 per cent was utilised. Perhaps the utilisation ratio would have been higher had the loans been distributed more evenly over the years, instead of 'bunching' towards the end of the decade. The sharp pick - up in aid commitments towards the end of the decade, however, was a result of the programme assistance received by Sri Lanka. Programme aid as it is commodity tied, yields itself to more rapid

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utilisation, and to the extent it does, the capacity of the economy to absorb foreign aid is exaggerated. The main factors accounting for the quick turnover of such commitments into a flow of physical resources is that programme aid is provided in terms of specific quantities of commodities that are readily available. There are no substantive questions of product or price differences to be resolved and therefore, no time is lost while the ordered imports are fabricated or produced. Hence the time lag between commitment of a commdity loan and the receipt and the use of that aid is not much longer than it takes to have the commodity shipped. In the case of Sri Lanka, not only was the supply of commodities under programme aid readily available; the demand for them was also strong in view of the shortages that characterized the period. Thus, all the factors necessary were present in the case of commodity aid to yield a quick turnover of aid authorised into resource flows

Table III gives data relating to the volume and composition of programme aid made available by the aid consortium.

If the decade under review is divided into two; the period from 1960 to 1965 and from 1966 to 1970, the utilisation ratio for the periods are not markedly different. Funds available for disbursement as at 1.1.1960 was Rs 420.7 million while the sum actually disbursed was Rs 202.6 million giving a utilisation ratio of 48 per cent. The corresponding figures for 1966 - 1970 was Rs 626.3 million and Rs 258.9 million and the utilisation ratio 41 per cent. The ratio differs as one would expect, according to the source and type of aid. Total commitments of the U. S. A., U. K., and 'others' excluding the Socialist bloc as at the end of 1970 was Rs 1,646.9 million and the amount utilised was Rs. 1,231.0 million, i. e. 75 per cent of the aid committed. Total commitments of the Socialist bloc for the same period was Rs. 638.1 million and the amount actually taken up was Rs. 327.1

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TABLE III

Pledges Under Aid Programmes

(Rs. Million)

Programme	Form of Aid	Australia	Britain	Canada	Denmark	West Germany F.R.G.	France	India	Italy	Japan	U.S.A.		Total
First	Commodity	6.93	47.60	14.53	—	38.09	—	12.70	—	23.76	57.33	200.94	
	Project	—	—	4.98	—	21.43	—	—	—	—	—	26.41	227.35
Second	Commodity	4.59	47.60	11.23	—	29.76	36.65	—	—	23.76	83.19	236.78	
	Project	—	—	7.71	—	—	—	—	—	—	—	7.71	244.49
Third	Commodity	5.73	51.00	18.72	—	14.81	—	39.68	—	29.70	89.28	248.92	
	Project	—	—	0.83	—	14.81	—	—	—	—	—	15.64	264.56
Fourth	Commodity	5.40	50.00	23.67	—	18.14	45.81	—	23.81	29.70	104.17	300.70	
	Project	—	—	—	—	17.77	—	—	—	—	20.12	37.89	338.59
Fifth	Commodity	5.77	57.12	18.15	16.00	21.19	55.29	39.68	7.14	32.72	148.75	401.81	
	Project	—	28.56	11.00	—	22.31	—	—	—	—	29.75	91.62	493.43
	Total	28.42	281.88	110.82	16.00	198.31	137.75	92.06	30.95	139.64	532.59		1,568.42

Soure : Ministry of Planning and Employment.

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million or 51 per cent. The fairly sharp disparity in the utilisation rates of aid pledged by these two sources may be put down to three factors.

1. The long historical dependence of the economy on traditional sources of supply and the consequent emergence of an infra - structure dependent for raw materials and other inputs on established markets.

2. Consumer preference for brand names from internationally known manufacturers.

3. The composition and character of the aid disbursed by the Socialist countries.

The overwhelming proportion of aid committed by countries of the Socialist bloc was for financing the construction of specific projects. Capital assistance of this nature necessarily takes longer to be utilised than commodity or technical assistance, which type of assistance was important in the aid programmes of the U.S.A., U. K., and 'others'. This time lag in the commitment of project aid and its utilisation is mainly because of decisions that must be made relating to the location of the project, its design engineering and structural features. The lack of experience in constructing large industrial plants in developing countries also hampers speedy project implementation. Additionally, the lack of adequate infra-structure to support the projects envisaged may also have impeded rapid utilisation of project aid.

The fact that the project tied nature of aid from the Socialist bloc inhibited quick utilisation is indicated by the relatively low utilisation ratio for project aid as a whole. Total commitments of project aid as at the end of 1970 was Rs. 1,004.9 million while disbursements as at the end of 1970 was Rs. 539.7 million giving a utilisation ratio of 54 per cent which approximates closely to

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the utilisation ratio of aid from the Socialist bloc of 51 per cent. The utilisation ratio for Non-Project aid on the other hand, differs substantially from that of Project aid. Total commitments and disbursements for the corresponding period was Rs. 1,554.3 million and Rs. 1,143.4 million respectively and the utilisation ratio 74 per cent.

Capital aid or Project aid is functionally related to the rate of domestic capital formation. Therefore, increases in the rate of capital accumulation will ipso facto raise the absorptive capacity of the economy for this type of aid. A pick-up in capital aid utilisation may also be expected as experience is gained in using external capital aid for imports and as projects conceived reach a stage of development where capital imports assume over - riding importance.

(III) Terms and Conditions of Aid

The overwhelming proportion of aid made available to Sri Lanka has been project tied or currency tied. With the commencement of programme aid the value of aid not specifically tied to projects increased. The total value of project aid pledged as at the end of 1970 was Rs. 1,004,862,840 while the value of non-project aid pledged (excluding PL 480) was Rs. 1,218,136,633.

Bi-lateral Aid

Sri Lanka has received assistance on a bi-lateral basis from a number of countries. They are Australia, Britain, Canada, Peoples Republic of China, France, Federal Republic of Germany, India, Japan, New Zealand, Poland, Sweden, U. S. S. R., U. S. A. and the Socialist Federal Republic of Yugoslavia.

The terms and conditions of external aid are to a great extent determined by the internal economic structure of donor

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countries as well as by their politico-economic philosophy. The favourable or unfavourable nature of these terms and conditions will determine whether these transactions have any aid component or grant element at all or whether they are motivated by nothing more altruistic than the good of the donor country.

Loans from the U. S. A., U. K., Canada, Australia and other non socialist countries have been generally more flexible as they have not all been project tied; while the amortisation of the loan itself is spread over a period of 15 to 20 years.

The assistance made available by the socialist countries of Eastern Europe differs significantly from other sources. Sri Lanka has received loans from the U. S. S. R., Poland, Yugoslavia and the German Democratic Republic. The value of aid authorised by these countries as at the end of 1970 was Rs. 638.1 million, or 25 per cent of total aid pledged. A striking characteristic of all these loans is their very short maturity periods. Only one credit from this source exceeds 10 years. This is from the U. S. S. R. and is repayable in 12 years. Grace periods attached to these loans are also comparatively low. Six loans have been contracted from this bloc and four loans carry grace periods of one year each; while one U. S. S. R. credit has a grace period of seven years. A Yugoslavia credit of three years maturity has a grace period of 5 years. As against these stringent conditions, there are two favourable features. Firstly, the rate of interest is comparatively low, 2½ per cent for the loans committed except the Yugoslavia credit which is 3 per cent. Secondly, it is open to Sri Lanka to repay some of these loans by exporting local products acceptable to the donors. This form of payment would bear less heavily on the balance of payments and may proved a stimulous to local manufacturing industry.

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The grant element in aid

While the quantity of foreign aid is important, of much greater importance is the quality of aid. However this distinction between quantity and quality while valid is largely conditioned by the nature of the enquiry. Thus from a foreign exchange or balance of payments stand point untied loans (project, commodity or currency) would rate higher than a tied loan. Likewise if one is interested in promoting agriculture or industry, the relative qualitative considerations will be different. Broadly, however, the quality of the resources flows generated by aid may be measured by the "real cost" to the donor or the "real benefit" to the recipient. This may be done by seeking the present value to the lender of the future flow of repayments. The grant element in a loan would be positive if the loan is authorised at a rate of interest below the going market rate; if on the other hand the market rate of interest is equal to the loan rate the present value would approximate the amount of the loan and the grant element would be absent. If the market rate of interest is lower than the rate at which the loan is made, it represents a gain to the donor, in that, the loan is made out at a rate of interest higher than that could be got in the open market.

Table IV gives the grant element of a sample of loans by source. The grant element has been calculated by computing the present value of the repayment streams of interest and amortisation, discounted at each donor's market long-term interest rate. The difference between the amount of the loan and the present value is deemed to be the grant component of the loan. It arises from the difference between market rates of return on investment and the lower return forthcoming from loans made as 'aid'.

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TABLE IV

Grant Equivalent of Selected Loans by Country

Country	Year Autho-rised	Value	Rate of Interest p.a.	Maturity	Rate of Interest in donor country p.a. (Long Term)*	Equivalent	Ratio of Grant Element to Loan (%)
U. S. A. (a)	1959	US$ 5,436,855	3.5	30 years	4.0	US$ 786,994	14
(b)	1967	US$ 7,390,445	3.5	25 years	5.0	US$ 2,130,527	29
U. K.	1966	£ 2,000,000	Free	25 years	7.0	£ 1,227,860	61
Germany, Federal Republic of	1967	DM 17,186,682	3.0	25 years	6.5	DM 6,307,804	36
Canada	1968	C$ 1,250,000	Free	50 years	6.8	C$ 954,317	76
Japan	1967	Yen 1,799,303,511	5.25	10 years	8.0	Yen 417,098,227	23
U. S. S. R. (a)**	1961	Rbls 1,000,000	2.5	20 years	5.0*	Rbls 250,534	25
(b)	1967	Rbls 1,000,000	2.5	20 years	6.0	Rbls 330,000	33

Notes: * The rate of interest used for discounting is the rate of interest on Long-Term Government Bonds.

** In the absence of a 'market' rate the rate of discount used is the average of Long-Term rates prevailing in Europe at the time the loan was made.

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According to the Table, Canada and the United Kingdom show the highest grant element in their loans with ratios of 76 and 61 per cent respectively. Both these countries have authorised loans free of interest, however, the Canadian loans though quantitatively smaller have been more liberal because of their longer maturity. The U. K on the other hand has authorised a much larger volume of assistance to Sri Lanka and their disbursement has been over a wider range of products. Assistance from the U. K. has also been more flexible and elastic as they have not been tied to projects. They are of course currency tied Two Canadian loans were specifically related to projects-Maskeliya Oya Project and the development of the Bandaranaike International Airport the other loans were commodity tied - e. g. to finance imports of asbestos fibre and newsprint.

The grant element of the two U. S. loans analysed are not very high, but given the magnitude and the wide sweep of American assistance the grant element indicated is not altogether insignificant. The two U. S. loans analysed have amortisation periods of 25 and 30 years.

The two loans from U. S. S. R. show grant ratios of 25 and 33 per cent. The accuracy of this ratio is, however, open to question in the absence of market rates in the U. S S. R. The rate used for discounting the repayment streams in this case is the average of long term interest rates prevailing in Western Europe in the year the loan was authorised. At best therefore, the ratios derived are more an indicator of the "real benefit" accruing to the recipient than of "real cost" to the donor.

The grant element of loans as indicated in the Table is, however not conclusive, as most official aid was tied to procurement in the donor country. If the tying of aid in this manner compels the recipient to pay more for purchases than would be

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necessary on a competitive basis, the grant element will be correspondingly reduced. However, there are problems that crop up, if prices in the donor countries are also brought into the calculation. Clearly the lack of complete homogenity of commodities traded is one such problem. Again, world prices may not always be the appropriate guide to donors' cost of production. The aid giving country may simply be a high cost producer of the range of commodities that enter into the aid relationship. If this is in fact so, the lower world prices for the goods in question does not eliminate or reduce the concessional element of the loan. In other words, if aid donors' goods cost 10 per cent more than the world market, it does not mean that the grant element is also reduced pari passu. While this is of course true as far as the donor is concerned, it certainly reduces the "value" of the loan to the recipient since the commodities linked to the aid agreement are priced above world market levels. Thus it is possible for the grant element as viewed from a standpoint of the 'real cost' to the donor to diverge substantially from the 'real value' or benefit as seen from the standpoint of the recipient.

(IV) Impact of Aid

The impact of aid on the recipient country is not restricted to the economy alone, its influences emanate into the social and cultural fields and perhaps, influences the politics of the recipient to a greater or lesser degree. Here, however, the analysis will be restricted to the impact of aid on the economy.

Mention has already been made of the vital role of foreign assistance in relaxing the constraints that impede the development and expansion of economy. Two basic constraints in Sri Lanka have been the inadequacy of foreign exchange and domestic savings to finance a higher rate of capital investment. The inadequacy of foreign exchange has been amplified by the high import content of both investment and consumption expenditure

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in Sri Lanka. The direct import content of gross domestic fixed capital formation in 1970 was 20.4 per cent, while the import content of private consumption was 15.9 per cent.

Impact on agriculture

It is difficult to give a precise quantitative estimate of the aid flow into agriculture. The bulk of the assistance under this head has been food aid from the U. S. A., Canada and Australia. However, the aid received by this sector also included such products as fertilizer, agro-chemicals and pesticides, tractors and commercial vehicles together with foreign aided expenditure in connection with irrigation, drainage and the reclamation of low-lying areas. Mention might also be made of the beneficial effects on the agricultural sector of aid financed infra-structural development.

There are many problems facing agriculture in Sri Lanka and the very nature of these problems limit the usefulness of foreign assistance in their solution. Agricultural development in the semi-subsistence sector of Sri Lanka requires better organization, better technical training, improved irrigation facilities, better seeds, large quantities of fertilizers and the diversification of crops. The availability of fertilizers have been increased as a result of aid imports while a number of Ceylonese working in different aspects of agriculture have been trained abroad and many foreign experts have given the country the benefit of their advice. Despite these very important forms of assistance received, food aid by far has had the most sizeable impact.

The main argument for food aid is that it enables the economy to sustain a higher rate of investment. Nevertheless, it cannot be implied that there is any automatic mechanism between the grant of food aid and the increase in the rate of investment. The availability of food does not by itself increase the rate of investment by an equivalent amount. It may merely lead to an increase

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in consumption with no impact on the rate of capital formation. Food aid, it appears, has in Sri Lanka substituted for domestic saving which would have been imposed by Government had this aid not been forthcoming.

The argument that food aid releases resources for investment is hardly tenable in Sri Lanka, because of the food subsidy scheme in operation. Food aid in the form of flour and rice which accounted for 43 per cent of flour imports and 13 per cent of rice imports in 1971 has assisted the authorities in maintaining its consumer subsidy programme. It is thus arguable that the food aid received by Sri Lanka has in fact not released resources either domestic or foreign for investment and that what it has done is to support a exaggerated and high-level of consumption to the detriment of saving and investment.

The notion that foreign exchange is 'saved' or released through the receipt of food aid does not also appear to hold in the context of the food subsidy scheme in force. It is true that in the alternative there would have been an immediate claim on foreign exchange to meet the volume and value of imports to maintain the food subsidy scheme, but it is also equally true that the import bill itself is an inflated one; inflated by the subsidy on consumption. The 'saving' is thus illusory and conceals the fact that the volume, value and composition of imports would have been different in the absence of the food subsidy. In the absence of food aid, it is also reasonable to presume, that the burden of subsidising consumption of food would have proved too onerous and would have been abandoned or drastically reduced. Had this been done, its contractive effect on government expenditure would have reacted favourably on the whole economy through its anti-inflationary impact.

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Impact on Industry

Manufacturing industry in Sri Lanka is of recent origin, and arose in the wake of the import and payment controls introduced in 1960 and intensified thereafter. Consequently, the structure of industry as it emerged was largely conditioned by the immediate need to save foreign exchange. However, while this was the objective of industrialization its initial effects were to introduce a new source of demand for foreign exchange; the demand for capital equipment and raw meterials to feed the new industries. Industrialization as it gathered momentum tended to change the complexion of the country's imports, whereas prior to 1960 the imports of finished products dominated the import structure of the country their relative share tended to wane as the decade progressed. Total imports by the private sector (at c. i. f. values) of investment and intermediate goods in 1960 was Rs. 491.7 million while in 1970 the corrrsponding figure was Rs 881.7 million. In 1960 the share of this class of imports in total imports was 27.8 per cent while in 1970 the corresponding ratio was 40 per cent.

The role of external assistance, in assisting this industrial expansion cannot be easily isolated. However, its importance may be inferred from the fact that the rate of growth of industrial production increased very substantialy in 1968, 1969 and 1970 when the import of most categories of intermediate and investment goods were brought under Open General Licence. This liberal import policy was largerly sustained through foreign borrowing. Nevertheless, it must not be forgotten that aid flows though important, constitute only a fraction of the total development effort that has been made. The results achieved therefore, are inextricably woven with the results flowing from the very much greater national effort. To attempt to isolate the contribution directly made by external resources and to subject it to quantitative measurement would thus appear to be a futile exercise.

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The chief impediment to the accelerated expansion of manufacturing industry during the period was the shortage of foreign exchange to finance the import of plant and equipment. The receipt of foreign aid hardly touched the fringe of this problem in the early years, and it was only after 1965 that this source of finance reached any sizable proportions to have any impact on the country's capacity to finance imports.

Not only did aid inflows increase after 1965, but the manner in which it was authorised and disbursed also tended to accentuate its impact on the balance of payments. The aid authorised after 1965, was programmed to relax the constraint on resource use arising from Sri Lanka's balance of payments position and therefore took the form of commodities that could be readily absorbed.

Table V below gives the total value of imports and foreign aid disbursed from 1960 to 1970:

TABLE V

Import Payment and Foreign Aid Disbursements

(Rs. Million)

Year	Total Imports (1)	Investment and Intermediate goods (2)	Foreign Aid Disbursements (3)	(3) as a ratio of (2)
1960	1960	752	36	4.8
1961	1703	722	23	3.2
1962	1660	746	48	6.4
1963	1490	696	83	11.9
1964	1975	702	85	12.1
1965	1474	675	78	11.6
1966	2028	831	153	18.4
1967	1738	771	245	31.8
1968	2173	1012	250	24.7
1969	2453	1292	377	29.2
1970	2313	997	314	31.5

Sources: Central Bank of Ceylon.

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Impact on foreign trade

The course of foreign trade has been directly affected through the mobilisation and use of foreign aid. Sri Lanka's imports have been directly affected and exports, to a lesser degree, indirectly. The value of imports from the British Commonwealth declined by 3 per cent over the decade, while imports from the United Kingdom have dropped by as much as 24 per cent. As against this the U. S. S. R., the People's Republic of China and the Eastern European Socialist countries have shown phenomenal expansion in their exports to Sri Lanka. The U. S. S. R. exported goods worth around Rs. 6 million in 1960. This figure had increased to Rs. 39.8 million in 1970-an increase of over 500 per cent! Imports from the Eastern European Socialist Bloc were equally significant. The increase in imports from China though relatively much less was not unimpressive - over 100 per cent. It must also not be forgotten that in absolute terms imports from China were substantially more than that from the U. S. S. R. or the Eastern European Bloc.

The increase in imports recorded from the Socialist countries cannot be linked directly to aid receipts. In fact, other factors such as the improved political and cultural relations with these states and the conclusion of trade and payments agreements also played a part. Notwithstanding this, however, the grant and utilisation of aid was undoubtedly a factor in modifying the pattern of imports and reducing the country's dependence on traditional sources of supply.

Table VI shows the utilisation of external assistance as a percentage of total imports from selected sources.

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TABLE VI

The utilisation of External Assistance as a percentage of total imports from selected sources 1960 - 1970

Country/Zone	Imports (Rs. Mn.) (1)	Aid Utilized (Rs. Mn.) (2)	(2) as a % ratio of (1)
U. S. A.	1,045,893,869	401,644,469	38.4
Canada	251,151,304	88,451,148	35.2
Federal Republic of Germany ...	963,931,874	190,854,477	19.8
Peoples Republic of China ...	1,926,701,326	99,574,899	5.2
U. S. S. R. ...	692,293,647	92,599,630	13.4
Socialist Bloc excluding China ..	1,578,135,647	227,522,019	14.4

Sources: Central Bank of Ceylon and Ceylon Customs Returns.

As far as exports are concerned, the influence of aid has not been greatly marked. Firstly, no significant diversification of exports has occurred. Secondly, the destination of exports has not altered materially. But this is not altogether surprising in view of the factors that militate against the rapid diversification of exports. The biggest obstacle appears to be the nature of the country's export produce, chiefly tea for which the demand is concentrated in the U. K. and other countries with a strong Anglo-Saxon influence. A further drawback is that the traditional exports are also primary products for which the demand is more or less static. A wider diffusion can only be realised with the development of a viable manufacturing sector capable of competing effectively in foreign markets. Much of the manufacturing units hitherto established had as their objective the domestic market, but with the limitations imposed by the size of this market and government's active encouragement of export-oriented industry, these objectives are likely to change.

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The fact that manufactured goods have already figured as exports, though admittedly on a small scale, is perhaps, symptomatic that industry will move out of its insularity and begin to look for wider horizons. Exports to the U. S. S. R. and Eastern Europe[1] which in value and relative terms was insignificant at the beginning of the decade assumed reasonable proportions by the end of the decade. The total value of exports to the region in 1970 recorded Rs. 174 million, nearly 9 per cent of the total value of exports. A major reason accounting for the sharp increase in exports to the Socialist Bloc has been the conclusion of trade and payments agreements with these countries. Aid agreements concluded with some of these countries, notably China, have also helped because of their willingness to take local exports in settlement of loan obligations.

Thus, despite the drawbacks to export diversification arising from the structure of the export sector which is dominated by three primary products and the still under-developed industrial sector with its bias towards the home market some progress has been made, new markets and new products have made their appearance and with it has emerged an increasing awareness of the need to sell abroad.

Technical Assistance

During the last decade, there have been significant transfers of technical skills from advanced countries to Sri Lanka. Many countries have provided Sri Lanka with scientific and technical equipment for research and higher studies. A large number of Ceylonese have also gone abroad for training and study. Many foreign experts and scientists have come to this country and

1. Eastern Europe includes Bulgaria, Czechoslovakia, German Democratic Republic, Poland, Rumania and Yugoslavia.

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imparted their knowledge. Along with the provision of capital equipment and machinery for setting up industrial units, some countries especially the Socialist Bloc have provided local technicians with in-plant training. The main sources of technical assistance have been the Commonwealth under the Colombo Plan and the specialized agencies of the United Nations.

Besides the direct influence of technical aid in raising and developing skills in particular sectors that are deemed strategic from a national point of view, its most important contribution has been its role in enhancing the capacity of the economy to absorb more capital; both domestic and foreign, This capacity which is directly connected with the level of the country's technological attainment is clearly dependent on imported skills and equipment. To the extent that this technical vacuum was filled by this form assistance it has increased the productive capacity of the economy and its capacity to absorb more capital.

(V) Summary and Conclusions

Sri Lanka received commitments of external assistance amounting to Rs. 2,559,129,813 during the decade 1960-1970. Of this sum, Rs. 1,682,060,329 was turned into imports of goods and services during the period and the balance was carried forward for utilisation. Capital imports or capital-related imports on project aid accounted for some 32 per cent of aid utilised, while non-project aid accounted for the balance 68 per cent·

However, looked at, whether from the point of view of commitments or utilisation it is clear that the aid received by Sri Lanka has been substantial, especially as external assistance was a relatively new phenomenon. Countries of the west accounted for some 63 per cent of aid pledged, while the Socialist Bloc contributed about 25 per cent and multi-lateral

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sources for some 11 per cent. Western aid was loaned as well as granted, while aid from the Socialist Bloc during the decade was invariably loaned, and tied to specific capital projects.

The use and responsiveness of aid to Sri Lanka's needs

The acceleration of external assistance utilisation noted towards the second half of the decade indicates that Sri Lanka found it both expedient and possible to secure aid and convert these aid commitments into resource flows with greater speed. This improvement in aid disbursements and use is the result of a number of factors. Of this, the most important was the change in the composition of aid flows that occurred after the commencement of programme aid which took the form of commodities directly usable and for which the local demand was strong. A substantial part of this aid was made up of agricultural commodities which could be moved quickly since supplies were in existence and no time was lost in tendering or in the appraisal of bids. Disbursements of assistance was also facilitated as the tempo of development activity increased and as aid financed projects started earlier in the decade reached stages at which, payments, for construction, delivery and erection were required. A further factor making for quicker disbursement and utilisation was the improvement in the administration and execution of aid programmes together with the experience gained in using external assistance.

While the factors outlined above were important, the most significant factor was the rapid depletion of Sri Lanka's foreign exchange resources. This was the combined result of adverse movements in the terms of trade and the difficulty of containing imports to a level compatible with the country's external receipts. This factor imposed on Sri Lanka an immediate need to expedite the use of external assistance.

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The aid received by Sri Lanka during the decade covered a broad range of local needs and was the source of approximately Rs. 538.7 million of capital plant and equipment (project aid utilised) and Rs. 1,143.4 million of commodities some of which was of a directly consumable character, while others served as raw materials and inputs for industry. An important and basic function of external assistance in the context of Sri Lanka's economy was the bridging of the gap between what was available domestically and what was essential to the economy to maintain a tolerable level of investment. In this process external assistance served to bridge three different resource gaps. If these resource gaps were not bridged by aid inflows there appears to be little doubt that the country's development efforts would have been impaired.

The first of these resource gaps that aid inflows helped to bridge was the current income and production gap. This gap reflects the inability of the domestic economy to produce the food requirements necessary to maintain current consumption and raw materials necessary to maintain current output. This gap was largely filled by programme aid in the form of food commodities and raw materials and spare parts that were in subsequent stages transformed into current income and product. Assistance of this type was in a sense 'consumed' by the economy and did not enhance future income as aid directly linked to capital formation tends to.

The second resource gap was the shortfall in domestic savings relative to the level of investment. This deficit was to some extent bridged by the flow of aid which had the effect of financing the 'uncovered' volume of actual domestic investment. The importance of this supporting role of aid derives from the central role of investment in promoting economic development. These two functional gaps are mirrored in the island's balance of payments statistics which reveal persistent deficits on the current account of its external payments.

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The third resource gap is a technical one and reflects the difference between the technology available and what is required to begin and sustain a level of economic growth based on the expansion of industry. Foreign technical assistance has reduced the inhibiting effects of the country's technical backwardness through the provision of a wide variety of technical services and has helped to advance Sri Lanka's domestic technology and expand her capacity to absorb large doses of investment.

The character and composition of external assistance received while thus proving invaluable to Sri Lanka's efforts to diversify her economy and increase output was not, however, wholly tailored to meet the needs of the economy. This is borne out by the considerable degree of under-utilisation of aid For all aid as a whole the ratio of utilisation was 65.7 per cent. While lags in the utilisation of aid are inevitable due to technical factors, the fairly large ratio of aid under-utilised in the case of Sri Lanka, perhaps indicates that some proportion of the aid pledged was not directed to specific deficiencies that chracterised the economy.

Terms of Assistance

Sri Lanka received assistance in the form of loans and grants. Grants were most frequently associated with agricultural produce and technical services. Capital goods of either investment or producer type were mainly made available on a loan basis. Given the domestic economy's need for a considerable volume and variety of external resources, the receipt of aid in this assorted form appears to have been a practical arrangement.

What is, however, open to question is the interest rates levied on some loans and the grace and amortization periods carried on others, as a consequence servicing of debt is emerging as a problem to be reckoned with.

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Table VII gives data relating to debt service payments as a ratio of export receipts. These debt service payments are made in foreign exchange and can be expected to increase as new loans are contracted. Thus, a significant share of future income and product, saving and export proceeds that could assist economic development will have to be channelled abroad to meet obligations incurred. The withdrawal of resources of this magnitude from the domestic economy will undoubtedly tend to impede development. Debt servicing and repayment requirements will, therefore, probably be added to the real resource needs of the economy, and both will have to be financed by a greater flow of aid. The volume of aid necessary is therefore, likely to increase and not decrease.

TABLE VII

Debt Servicing Ratio for Sri Lanka 1960-1970

Year	Amortisation		Interest	Total Service Payments	Export Earnings	Total Service Payments as % of Export Earnings
	Long-Term	Short-Term*				
1960	—	15.7	17.6	33.3	1796	1.8
1961	—	—	36.5	36.5	1707	2.1
1962	6.1	—	18.3	24.4	1763	1.4
1963	6.3	—	20.8	27.1	1708	1.6
1964	71.1	—	20.4	91.5	1767	5.2
1965	40.7	55.3	24.5	120.5	1909	6.3
1966	30.2	77.0	24.0	131.2	1674	7.8
1967	44.4	17.9	32.5	94.8	1650	5.7
1968	60.8	174.4	41.7	276.9	1976	14.0
1969	77.0	284.3	56.8	418.1	1909	21.9
1970	112.9	523.0	99.7	622.7	2016	30.9

Source: Central Bank of Ceylon.

* Includes payments made on account of Suppliers' Credits and I.M.F. repurchases.

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In conclusion, it may be said that the modest achievements of the decade in the way of economic development and diversification while largely a result of domestic effort and enterprise was also due to the availability of external resources form abroad. Thus, while domestic forces were the main factors in the development process, as in fact they should be, there is little doubt that the supplement to domestic efforts provided by external resources was of vital importance in the decade studied.

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Foreign Exchange Problems and Experiences in some selected South East Asian Countries

WARNASENA RASAPUTRAM

Introduction

The Sterling devaluation of September 1949 resulted in a world-wide adjustment of exchange rates against the dollar. The degree of depreciation depended on the trade relations of the country concerned, degree of internal inflation, the position regarding the movement in the terms of trade, the presence or absence of effective monetary and fiscal policies and the volume of international reserves that were available. The amount of depreciation ranged widely (with Thailand on the one hand and Indonesia on the other extreme). The following table shows the extent of depreciation experienced by these countries calculated on the basis of the exchange rates prior to and after devaluation.

The use of exchange rates as a tool of balance of payments adjustment has had a mixed reception in the countries of the region. While some countries were more inclined than even industrialised countries to use the exchange rates, others were willing to adjust their rates only to keep the alignment with their trading partners. A few countries like Thailand, Philippines and

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Country	Currency Unit	EXCHANGE RATE (Units of national currency per US $)					Exports (US $ MN.)
		1948	1972	Change	Change x 100 / 1948 Rate (Rate of depreciation)	Change x 100 / 1972 Rate (Rate of depreciation)	
Thailand ...	Baht[1]	13.70	20.80	7.10	51.8	34.1	831[2]
Philippines ...	Pesos	2.00	6.78	4.78	239.0	70.5	1.084
Sri Lanka ...	Rupees	3.309	6.395	3.086	93.3	48.3	307
Indonesia ...	Rupiah[1]	2.65	374.00	371.35	14013.2	99.3	1.247[2]
India ...	Rupees	3.309	7.707	4.398	132.9	57.1	2.362
Pakistan ...	Rupees	3.309	11.000	7.691	232.4	69.9	529
						TOTAL	6.360
					Average depreciation for all countries weighted by exports for the year	65.4	

Source : I. F. S.

[1] Rate of exchange for exports
[2] Exports for the year 1971

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Indonesia shifted to multiple rates, while others were quite happy with a unified fixed rate. Thus these two sets of countries made adjustments of the rate either on the basis of changing trends in commodity markets or to take account of the different levels of inflation that were developing. The countries did not have any intervention policies. In most cases they were fixed by an upper and lower limit. There was the case of Thailand when it experimented with an exchange rate to intervene with market rates where necessary. Apart from these instances, intervention points were not very common.

Most of the countries in the region have kept their reserves in liquid form. In some cases currency circulation had to be backed fully by external assets. There had been cases where these reserves had been invested in non-liquid form by the Central Banks. The management of the reserves normally have no particular effect on the day to day exchange rate movements, but the type of assets held may well decide the country's policies in case of exchange rate adjustment of major international currencies. Predominantly these were held in Sterling but recently there had been a move to diversify the reserves into different currencies.

In 1967, at the time Sterling was devalued, several countries either did not follow the Sterling devaluation or followed certain independent policies. It was certain that in view of Britain's entry into the E. E. C., the commitment to allow free movement of capital within the enlarged E. E. C and the eventual disintegration of the Sterling area was a matter of time. The break up of the Sterling area made several countries remain pegged to the dollar and not float with Sterling. Some countries have been running down their reserves in Sterling upto the minimum of 36 per cent agreed at Basle so that they can diversify their holdings of reserves currencies. Because of growing U. S. investment and the strength of the Deutsche Mark as an international

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currency there is an added demand for a higher degree of diversification of their reserves.

During the last 25 years several countries experimented with multiple rates of exchange. The average rate of depreciation of the currencies of those countries was higher than those with unitary rates. In most cases internal price instability heightened by fiscal and monetary factors caused a large degree of depreciation of these currencies. The adoption of the Foreign Exchange Entitlement Scheme in Sri Lanka, the Export Bonus Scheme in Pakistan and similar instruments in Indonesia and Thailand, was mainly directed towards adjusting the exchange rates to keep pace with the internal price movements.

Sri Lanka

Sri Lanka's problem is that, given the present export and import structure, there is very limited scope for the manoeuvre ability of the exchange rate for immediate export expansion or import curtailment. The dependancy status with three export products – tea, rubber and coconut – and a large number of essential import items makes it highly vulnerable to foreign economic disturbances. A fall in income and investment of a major customer of Sri Lanka can cause a more than proportionate reduction in her exports and income Thus, Sri Lanka is in a dilemma. Without a structural breakthrough it cannot effectively cushion the impact of foreign economic disturbances; it cannot obtain the desired breakthrough in her economic structure without adopting bold policies in respect of exchange rate, monetary issues and fiscal matters.

Instability of Sri Lanka's major exports can be gauged from the fluctuations in price, volume and value. The average year to year fluctuations in prices, for both tea and rubber, have been most twice that of volume; the value fluctuations

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indicate that variations in price and volume moved in the same direction. Instability caused by such fluctuations reduced export incomes, caused uncertainties and impaired import capacity The non-adaptability of the economy to changes in relative prices worsened the situation. The price elasticity of demand for major exports is less than unity, while the price elasticity of demand for Sri Lanka's essential imports is also less than unity. Nearly 50 per cent of the imports are essential imports, while 90 per cent of the export earnings come from the three major products.

The instability generated through external factors is further deepened by the existing structure and the rate of growth of the economy. Population growth remains high and is accompanied by low productivity both of labour and of land. The industrial base is relatively small. Gross National Product in per capita terms rose at an annual average rate of 2.0 per cent between 1960 and 1971. Savings remained low, while expenditure was in excess of income for most part of the last decade. Sri Lanka lived beyond its means. It was able to finance this excess expenditure by drawing down accumulated foreign assets and by foreign borrowing and assistance. Until the situation became very acute no serious attempt was made to steer the economy towards equilibrium. Curiously the policies adopted pulled the economy more out of alignment than remedying the existing structural weaknesses. The inability to take clear-cut decisions was because the entire exchange rate adjustment procedure was mixed up with the need to take hard political decisions.

A small country like Sri Lanka, with heavy dependence on foreign trade, may sometimes find it difficult to decide when a fundamental disequilibrium may have actually set in. The presence of controls tend to conceal the real issue and postpone the need even for the search for a solution. Disruptive short

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term capital movements do not play any significant role in the international transactions of a country. Cyclical factors have played a vital role in recessions and recoveries. Accordingly, any balance of payments deficit is treated as a temporary phenomenon amenable to counter cyclical policies. But when structural weakness began to show up Sri Lanka was not ready with a solution. Instead, the authorities were more concerned with the distribution of the national product rather than increasing the national product through policies geared to economic development. Their policy of pampering the consumer favoured a high consumption rate rather than a high rate of savings and investment.

Historical factors made it difficult for the policy maker to pull the economy out of a morass of decisions that had been taken to favour one class or another without due consideration been given to the development needs of the country. This was accentuated by historical ties that stemmed from colonialism. It was imperative that Sri Lanka's policies did not conflict with those of Britain at least during the first few years after independence.

Prior to the establishment of the Central Bank in August 1950 Sri Lanka had a dependant currency system by which the Ceylon rupee was linked to Sterling through the Indian rupee. Thus Britain forced Sri Lanka to finance her war effort by offering Indian rupees which were obtained by lodging Sterling securities with the Bank of England. Since Sri Lanka had to support Britain's effort it went on accumulating Sterling balances which were not available to import the required goods. The war torn economies of the West reduced their demand for goods from Sri Lanka. Import demand, however, remained high despite a fall in export incomes. The balance of payments situation deteriorated and reserves declined. Several controls were imposed to stop the drain on reserves. The government was very sen-

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sitive to a possible increase in the cost of living. A mixed situation developed. Import and exchange controls caused scarcities. In order to prevent a rise in living costs, prices of many items that entered as mass consumption of lower income groups were controlled. To ameliorate the adverse effects of falling export prices, rising unemployment and rising prices, subsidies were introduced in respect of rice and flour. Since there was no possibility of expanding the volume of taxes the extra expenditures to finance these subsidies had to be by non expansionary financing. Clearly, the resulting inflationary tendencies created a higher demand for imports and made the balance of payments situation to deteriorate further.

The decision that had to be taken in order to remedy this situation was not the extent of any devalution but the degree and severity of controls that were required. Sri Lanka, India and Pakistan followed similar policies at this time. The degree of controls would naturally depend on how much the exchange rate itself was over-valued. All these countries were in a stronger position to decide on a more positive approach towards the exchange rate if they were aware at this time that a 'fundamental disequilibrium' in the balance of payments had already developed. The balance of payments difficulties, however, were considered to be of a temporary nature and no corrective action through the exchange rate was considered necessary. In any case, import restrictions were important instruments of control that fitted in with the aims of economic planning at that time.

As mentioned earlier, the continuing balance of payments deficits of the United Kingdom forced her to devalue the pound Sterling in September 1949. Several countries followed suit. Sri Lanka and India devalued their currencies by the same percentage level of 30.5 per cent as the pound Sterling. Though Sri Lanka and India were also experiencing balance of payments difficulties

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they were not willing to take unilateral decisions in the matter of adjusting the parity rate. The rate of devaluation was such that it was intended to keep the links they had with the Sterling Area and within the British Commonwealth. Pakistan, however, decided not to devalue her currency and was motivated mainly by the elasticity pessimissms for exports and imports. Her agricultural commodities were such that they had a very low supply elasticity. In addition, commodities like jute had low demand elasticities abroad. This meant that total earnings from abroad will decline if exports do not expand by a percentage that was higher than the percentage devaluation of the currency. Imports, too, had a low elasticity; with price increases all-round after the devaluation this would result in higher foreign exchange losses. India, on the other hand, was building up its industrial base with larger supplies of steel, coal, electricity, cement and fertilizers. A devalution at this stage would give India an added incentive to raise production that will help future growth.

Sri Lanka's economic structure was comparable to that of Pakistan, except for one product - rubber - which was a dollar earner. However, her decision to devalue was not only due to historical ties alone, but was also mixed up with a number of other factors, such as, the inflationary situation at home and the worsening of the balance of payments position.

The effects of devaluation were mixed with those of the Korean boom. Export values increased substantially both as a result of a rise in export prices and export volumes. The rise in reserves by nearly 26 per cent between 1949 and 1951 strengthened the Ceylon rupee to such an extent that there was a talk of revaluation in certain circles. The Central Bank, in its Annual Report for 1951 (page 19), observed that there was no need to revalue the currency because the effects of the Korean boom would be temporary and it was considered appropriate to achieve

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a better distribution of income and lower living costs through a higher level of production and productivity and a promotion of a higher level of economic development in the country. However, to prevent serious inflationary forces from developing, imports were liberalised to ease the shortages.

As the Korean boom crashed in 1952 reserves also fell by nearly 50 per cent. The boom conditions in 1951 had stimulated a high consumption pattern with a heavy import orientation. This could not be sustained when export incomes fell except by drawing down savings. Balance of payments position became adverse and had to be protected by fiscal and monetary measures. Imports were once again restricted.

The measures taken had immediate results. Sri Lanka's economic recovery at this time was mainly because of restrictive fiscal policies to contain the food subsidy bill within tolerable limits. The prices of tea improved and the external assets which had dipped to a low level of Rs. 640 million in 1953 rose to levels beyond that attained during the Korean boom to Rs. 1275 million in 1956. Though there was a significant increase in money supply, mainly caused by the external situation, it did not cause any concern because the tea boom of this period resulted in an increase of income of tea producers whose propensities to save were known to be high.

Like India or Pakistan, Sri Lanka needed a large volume of foreign aid to fill the gap in the balance of payments. It was no doubt true that the economy was capable of a higher rate of growth (prior to 1957) than what was achieved. But the opportunities were missed. When there was a structural change in the demand for Ceylon's exports, she was not ready with new products. What could have been done with export promotion and import substitution was never attempted in the correct way. As

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long as the exchange rate remained over-valued there was an effective levy against import substitution in agriculture and food. This also intensified the difficulties facing an expansion in exports. When export industries are insufficiently competitive and import substitution is not only hampered but also misdirectcd so as to raise import dependance further, the balance of payments gap emerged as the biggest constraint against expansion of output, income and employment.

From 1957 onwards Sri Lanka's balance of payments continued to be in deficit. The following table summarises the position with regard to the current account.

Sri Lanka - Balance of Payments - $ Million

	1957	1960	1967	1968	1970	1971
Exports	350	377	347	332	339	330
Imports	370	421	417	396	392	375
Trade balance	- 20	- 44	- 70	- 64	- 53	- 45
Net Invisibles	- 21	- 2	+10	+ 4	- 6	+ 6
Current Account	- 41	- 46	- 60	- 60	- 59	- 39
Net Long-term capital	- 4	+ 5	+34	+38	+59	+71
Basic balance	- 45	- 41	- 26	- 22	—	+32
Net Short-term capital	—	- 5	+57	+31	- 2	- 32
Total External Assets	223	114	94	78	68	82

Source : Central Bank of Ceylon Annual Reports

It can be seen that no amount of positive and negative controls have been effective in arresting the trend in the loss of foreign exchange reserves. By 1960 the total external assets were nearly half the level of that prevailing in 1957. By 1966 these reserves had dipped to 30 per cent of the 1957 level or 15 per

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cent of the value of imports of that year. Though the balance of payments crisis deepened, Sri Lanka was not willing to take any drastic corrective measures. In the context of existing political conditions the Government was not willing to cut down its budget deficit, particularly because it arose from the subsidy on rice. Since bulk of the monetary expansion was due to government deficit, it was not possible to take effective monetary measures either. It was, therefore, inappropriate to curb the supply of credit to the private sector when the remedy was to curb expansion of bank finance to the government sector. In fact, the main impact of government deficits was to reduce external assets through increased money incomes that resulted in higher imports. The only course that was possible was to intensify import and exchange controls by banning the importation of certain types of goods.

Sri Lanka's import capacity has been seriously impaired by a fall in real export earnings, and a continuing deterioration in the terms of trade. Capacity to import continued to decline a indicated in the following table.

Capacity to Import - 1959 Prices

Year	Domestic Exports	Terms of Trade	Net Capital and Factor Payments	Capacity to Import	Actual Imports	Capacity to Import as % of Actual Import
1960	1,777	- 11	- 42	1,724	1,939	89
1966	1,928	- 505	- 48	1,375	1,740	79
1968	2,028	- 784	- 32	1,206	1,430	85
1970	2,102	- 916	+ 14	1,200	1,375	87
1971	2,023	- 955	- 67	1,001	1,098	91

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In 1971 capacity to import improved to 91 per cent of actual imports as against 87 per cent in 1970 and 69 percent in 1969. Tight import restrictions aimed at mainly reducing consumption demand have brought the import volume down to the present level. The per capita total imports have been reduced to about 65 per cent of the 1966 volume and per capita consumption imports to 62 per cent of the 1966 volume. Sri Lanka is in a dilemma with regard to her import policy. Drastic reductions in intermediate and investment imports are inimical to economic growth: cutting down of consumption goods below the minimum desired level will lower standards of living substantially.

For a long time Sri Lanka was more pre-occupied arresting a fall in the living standards than diversifying and expanding the non-traditional exports. It was a type of "stop-go" policy that resulted in cutting down imports at a time of severe exchange losses and import liberalisation when conditions improved. By the Sixties it was, however, clear that the rapid deterioration of exchange reserves would eventually constitute the biggest constraint limiting economic growth.

However, Sri Lanka cannot allow imports to exceed exports over a long period. Whilst the import demand is conditioned by population growth, rising incomes, marginal propensity to import and the need to maintain a high standard of living, growth of export demand is determind abroad. There has been a structural shift in the demand away from Sri Lanka's major exports. The new products have not made a big impact on export earnings for two reasons. The exportable surplus of these products have been limited by rising domestic consumption. In case this export surplus can be generated it has to find markets in developing countries. But these countries themselves are having serious balance of payments problems and have imposed temporary restrictions to safeguard their own balance of payments.

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Clearly, with a limited domestic market, the continued growth of output will depend largely on the degree of specialisation and the need to produce for export. Export orientation was adversely affected by the high prices obtainable in the local market. As long as rupee profits are high no effort is made to sell abroad. The table shown below indicates the slow rate of growth in industrial exports.

Industrial Growth

	1960	1963	1966	1967	1968	1969	1970	1971
1. Industrial production at constant prices (Rs. Mn.)	728	853	1008	1052	1154	1221	1335	1379
2. Growth rate over previous year		7.1	7.6	4.4	9.7	5.8	9.3	3.3
3. Industrial exports at:								
(a) Constant prices (Rs. Mn.)	73	73	70	80	88	89	122	128
(b) As % of domestic exports at constant prices	4.1	3.8	3.7	4.0	4.3	4.5	5.9	6.3

Source : Central Bank of Ceylon Annual Report 1971

High domestic prices relative to world prices prevent exports. In such a situation the exchange rate has to be realistic not only to give the necessary protective arm at the initial stages of its development but also provide a competitive base in world markets. There is no doubt that the scope for import substitution, particularly on food items and selectively on intermediate goods is fairly wide, but its development is intrinsically limited and cannot get the necessary acceleration owing to the narrowness of the domestic market.

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Most of these measures of import substitution had unfavourable side effects. Various controls resulted in the accumulation of windfall profits in the hands of importers. As long as the exchange rate was over-valued and interest rates on scarce capital remained relatively low, it was cheaper to import heavy capital equipment instead of developing labour intensive industries. Building up of capacity by importing capital goods and the need to import intermediate goods to maintain existing capital stock resulted in a substantial drain on foreign exchange. Maintenance imports alone amounted to Rs. 300 million or 23% of imports. In the context of a growing deficit in the balance of payments, and the difficulties involved in altering the structure of import demand within a short period, Sri Lanka had to look for ways and means of building up the economy by making industries efficient, viable and outward looking and agriculture more dynamic.

Import substitution in agriculture, which had been neglected, was given various types of incentives in order to be able to save foreign exchange and thus be able to import a larger volume of intermediate and capital goods. The industrial structure was such that it was heavily dependant on imported raw materials. As a matter of fact this dependancy had not shown any significant tendency to decline in favour of local raw materials. Industries were able to produce and survive largely with foreign assistance in the form of commodity loans and spares for machinery. Invariably a decline in the volume of such assistance will cause production volumes to decline mainly due to the absence of an outward looking export oriented growth. However due to the policy of import substitution through protection most of the industries have been firmly rooted in the country at least to cater to the internal market. Inadequate allocations of raw materials would result in their inability to expand production and employ-

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ment. The rise in import demand - particularly by the upper income classes for luxury articles and travel - and a fall in export incomes pushed up the black market price of foreign exchange. Sri Lanka once again was not willing to take a unilateral decision to correct the over-valued exchange rate.

The persistent deficits in the balance of payments caused severe drain on foreign exchange reserves which reached crisis proportions by early 1964. The Government was, therefore, compelled to impose stringent import and exchange control restrictions which resulted in severe hardships to the growing industries. As mentioned earlier the foreign exchange crisis was caused by exogenous and endogenous factors. There was a shift in the structure of demand away from Sri Lanka's exports. This was aggravated by a rapidly worsening of the terms of trade and rising import prices due to inflationary tendencies abroad. The rising budget deficits had their repercussions, both on consumption and on the balance of payments. Consumption expenditure (public and private) rose by nearly 40 per cent between 1959 and 1967, compared to only a 10 per cent growth in export values. The industrialisation programme which was inward looking also required a large volume of imported intermediate and investment goods. The elasticity of demand for imports was in excess of the elasticity of demand for exports. The supply elasticity of exports remained low because of the structure of the economy.

There were serious price distortions. The relationship between domestic prices and foreign prices was distorted by the over-valued exchange rate which made imports cheaper and exports expensive. The working of the market mechanism had been severely restricted. The price mechanism did not work well, not only because of the over-valuation of the exchange rate but because of the presence of various rigidities in the economy.

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Economic growth was hampered due to the absence of the usual protective arm of a realistic exchange rate. In addition there was a loss of reserves due to improper invoicing and rising demand for imports. The level of reserves had dropped to low levels from about 54 per cent of value of imports in 1957 to about 20 per cent by 1967. Import capacity dwindled and the existence of an active black-market made it necessary to tighten import and exchange restrictions even more.

When Britain devalued the pound Sterling Sri Lanka followed suit and the rupee was devalued 20 per cent against the dollar. Sri Lanka went further by devaluing 7.5 per cent against Sterling. This amount of devaluation was considered to be adequate to meet the problems of major exports, but was not considered sufficiently liberal to provide the required incentives to minor exports As regards imports were concerned, the cost restrictions that were imposed could not effectively prevent a large volume of imports from flowing in, in view of the backlog of demand that already existed. At the same time a further degree of liberalisation was required to meet the growing sectors of the economy, but that too had to be attempted by placing further cost restrictions on top of the devalued rate. Therefore, it was considered relevent to introduce a multiple exchange rate system that would enable the Government not to impose further burdens on the bulk of consumers, while at the same time provide the necessary atmosphere for the growth sectors to expand.

A Bonus Voucher Scheme, almost on the same lines as that of Pakistan, was already in operation. This scheme had given rise to a number of multiple exchange rates. But the experience gained from this scheme indicated that a dual rate of exchange would provide better incentives for export promotion and expansion than a more depreciated unitary rate. It would also provide a realistic system of pricing of exports and imports on a selec-

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tive basis. Accordingly, the Foreign Exchange Entitlement Certi-ficate Scheme (FEEC) was introduced in May, 1968. The working of the scheme has been described in detail in the Annual Report for 1968 and may be summarised here.

All exports and imports were divided into A and B categories. The A category goods were free of FEECs. In the case of B category imports a further sub - division was made according to whether they were under Open General Licence (OGL) or quota system. All non-OGL imports required the surrender of Certifi-cates while in the case of OGL imports letters of credit too had to be opend. The B category exports were entiled to FEECs. All major exports and essential imports were put into the A category. At the start the FEECs were sold by tender and it was intended to be a floating system. The price fluctuations at the initial stages were large. Later when the nature of the scheme was understood the price of Certificates tended to settle down more or less around Rs. 44 per Rs. 100 of Certificates. Subsequently, the FEEC rate was fixed at 44 per cent above the official rate thus abandoning the floating nature of the scheme. The FEEC rate has since then been raised to 55 per cent upto November, 1972 and then to 65 per cent above the official rate.

The introduction of a completely new system of exchange rates and liberalisation of a number of items of imports made the importers speculate about the future of the scheme. There was speculative stock building at the beginning but this declined as business confidence in the scheme developed. Monetary policy made stocking of goods rather expensive. Though monetary policy supported the continuance of the scheme, fiscal policy was such that it led to conflicting objectives. The year 1968 was an exceptionally good year for Sri Lanka when the full effects of the 'Green Revolution' were felt. But the income distribution became more unequal as a result of the incomes not seeping down to

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the lower income earners. The high incomes, together with an unequal distribution of incomes that favoured imported goods, caused a rise in demand for imports thereby exerting heavy pressure on the OGL scheme. The OGL scheme was abandoned in 1970, but the FEEC scheme as such continued to be operative.

It is difficult to measure the effects of the Certificate scheme because of the shortness of the period. Within such a short period it is not possible to impart the confidence required to carry it through, especially after years of controls and restrictions. However, it may be said to have mixed effects. The realisation of the aims of the Certificate scheme depended on the ability to export more through higher production and productivity. The Certificate scheme had favourable effects on investment. Thirty-one foreign investment projects were approved at this time because of incentives offered to investors. The foreign exchange cost of these was $ 16 million; $ 7 million, of which amount, was to be provided by foreign investors. When the Certificate scheme was launched, $ 16 million was authorised for new projects, while suppliers financing upto $ 8 million was to be approved for new textile projects.

The introduction of the Certificates scheme had price effects, income effects and substitution effects. The price effects of this scheme depended on the elasticity of demand for a particular product and the amount of price increase that could have been absorbed by the importer or producer as a result of higher turnover realised (or expected) in the wake of higher incomes. There were instances when prices were jacked up by more than the amount of the Certificate rate, but fear of lower sales and larger supplies coming into the market restricted such price hikes to a minimum. Domestic costs of some of the inputs of industries rose thus resulting in a rise of factor costs and wage adjustments. But there was, at the same time, evidence of rising productivity

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which would have come about mainly as a result of expansionary skills and higher rate of utilization of existing capacity. There were beneficial effects on income and employment. Due to an expansion of output, capacity utilization and scale of activity, employment increased to take advantage of the rise in demand for goods and services Similarly, increase in cultivation and the drive towards substitution of imports resulted in increasing employment in agriculture as well. Private sector output in agricultural industries, construction and service industries increased sharply as a result of new investments not only in capacity but also in new plant and equipment. All these factors would have raised income and employment. Higher "taxes" by way of Certificates caused a certain amount of re-distribution of incomes.

The secondary and tertiary effects of this scheme could not be fully worked out because it was suspended by May 1970. The effect of the scheme on income could have been gauged from the rate of increase in value added in industry, which rose by 18 per cent in one year in money terms and 11 per cent in real terms. In 1969 it rose by 15 per cent and by 1970 it rose further by 7 per cent.

As regards the export of minor crops, they realised foreign exchange earnings equivalent to $ 25.6 million in 1968 and was an improvement over the previous year by $ 4.4 million. In 1969 it rose to $ 27 million, in 1970 to $ 36 million, but in 1971 it fell to $ 33 million. Most of the minor exports were agricultural commodities. Elasticity of supply of agricultural commodities is always low and immediate expansion of exports would come about only by a diversion of domestic consumption towards exports. In view of the small size of the domestic market such immediate diversions did not take place on a large scale.

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The rate has been fixed at 55 per cent for a long period. The availability of foreign exchange for defined purposes was not revised in accordance with market conditions. The price of foreign exchange is a function of the amount demanded and the amount that is available to be supplied to the market. The reduction in the supply of foreign exchange resulting from lower earnings from exports would have adverse effects on the country's reserves if exchange continues to be provided at a price that is not in consonant with current economic conditions in the foreign exchange market. The inability to make this scheme flexible and make it workable on a market basis caused heavy strains mainly at a time when incomes were rising after the boom year. Finally, the uncertainties that prevailed as a result of foreign exchange being in short supply resulted in heavy speculation which caused stocking of goods over and above the minimum required and also due to speculation in foreign exchange dealings. The OGL scheme was finally abandoned but the other features of the Certificate scheme continue. In 1972 November, the FEEC rate was revised to 65 per cent above the official rate.

India and Pakistan

The legacy of the second world war and the partition of the sub-continent affected both India and Pakistan. Productive capacity had declined and there were serious shortages of foodstuffs and basic raw materials.

By 1949 Indian imports reached a very high level, partly due to high import prices and partly due to shortages caused by the partition. Indian imports of cotton and jute increased but the exports did not rise that fast. At this time the Indian balance of payments was under heavy pressure. Two factors that were mainly responsible for this situation was the partition of the country which altered the structure of

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imports and exports and the release of pent up demand accumulated as a result of stringent war-time controls. Prior to devaluation, India lost Rs. 5980 million of foreign exchange reserves. However, the existing inflationary pressures were not considered serious. When Britain devalued economic ties had to be maintained. The Indian devaluation in 1949, like that of Sri Lanka, was in the ultimate analysis a routine measure so that the Indian rupee would be in step with other Sterling Area currencies.

The devaluation of the rupee in 1949 and the Korean boom of 1950 enabled India to stage an economic recovery. The reserves which declined by Rs. 130 million in 1949/50 turned into a surplus of Rs. 280 million in 1950/51. The higher import prices reduced imports while the expanded demand for exports resulted in a rapid increase in export incomes. The effects of devaluation were thus mixed up with the events of the Korean boom. The relatively comfortable position of the balance of payments coincided with the launching of the First Five Year Plan (1951-56). Since exports picked up there was some relaxation in the efforts to bring about structural changes through a higher rate of investment. The reduction of investment led to a slowing down of economic growth in subsequent years; this placed greater pressures on the balance of payments later on.

During the First Plan period (1951—56) of India, the balance of payments did not give much cause for concern. The end of the Korean boom and the recession in America were partly offset by very favourable agricultural and industrial output. The import and exchange control restrictions kept imports under check. The postponement of investment in the first two years of the Plan also reduced capital imports. But towards the end of the Plan period investments increased fast and there was a steep rise in imports. Exports also increased, both as a result of development efforts in the past and liberalisation policies of trading

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partners. The current account was in surplus throughout the period and there was no need to impose heavy restrictions of the type pursued by Pakistan.

It was noted earlier that Pakistan did not devalue her rupee in 1949. She had very good reasons for this course of action. She had a large volume of reserves accumulated in the past. In fact, during the pre-Plan period the Pakistan government deliberately ran down the foreign balance to ease the pressure on prices. Accordingly, the deficit financing operations were not out of tune with the accepted policy at that time. In 1951/52 there was a build up of foreign exchange reserves despite a high level of imports. But in the subsequent year there was a huge import surplus and the level of foreign exchange reserves was considered too low. The balance of payments policy shifted towards the adoption of restrictions. A foreign exchange budget was drawn up and import controls were imposed to stop a further drain on foreign exchange.

In response to serious balance of payments difficulties, Pakistan imposed stringent exchange and import controls. The foreign exchange reserves fell by Rs. 278 million between 1952 and 1954. The adverse effects of terms of trade, inelasticity of supply of export goods, low elasticity of substitution between home goods and foreign goods and the inflationary conditions caused by budget deficits led to a sharp deterioration in the payments situation. The fact that Pakistan was the only Sterling Area country that did not devalue in 1949 stood against her in the eyes of aid givers. Despite stringent controls large leakages of foreign exchange to consumption was possible. Internal inflation actually reduced the export supply. The import substitution programme was not working well. In these circumstances Pakistan devalued the rupee by 30 per cent in 1955 but continued to rely on restrictions on imports and payments. Devalution did not have lasting benefits.

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In the devalution year itself there was an export surplus and an addition to external reserves but in the following year it slipped back to the old pattern of import surpluses.

In the case of India the real exchange crisis occurred during the Second Plan Period (1956—61). The current account deficit reached a peak in 1957 due to a very high rate of investment that necessitated increased imports and a substantial increase in maintenance imports. In fact, seeds for this increase were sown during the period of the First Plan when the increase in capital goods imports rose by as much as 76 per cent. Servicing of industries set up during the period of the First Plan made heavy drafts on reserves during the period of the Second Plan. Furthermore, the Second plan was heavily weighted towards industrialization and the demand for foreign exchange exceeded Plan targets due mainly to larger investments in the private sector in certain types and directions not anticipated in the Plan. Obviously, the excess demand for imports could have been reduced through cost restrictions. Instead, import restrictions (with high tarriffs) and export subsidies were considered better instruments of balance of payments policy. India was trying to achieve the structural breakthrough in exports and imports through a higher rate of investment and savings. Accordingly, monetary and fiscal policies were adjusted in 1958 to meet the situation. The overall budget deficit of State governments of Rs. 1047 million in 1956/57 was reduced to Rs. 437 million in 1957/58. Deficit financing by the Central Government was reduced from Rs. 3810 million in 1957/58 to Rs. 2010 million in 1958/59. The rate of increase in money supply dropped from Rs. 1286 million in 1956/57 to Rs. 740 million. All these indicated that India preferred to control the situation through monetary, fiscal and import control measures in lieu of an across the board devaluation.

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Pakistan's devaluation in 1955, it was noted, achieved success only for a very brief period. Severe exchange and import controls were in force from 1954. Notwithstanding the high priority (given in the First Year Plan 1955—60) for capital goods imports, there was a reduction in foreign exchange allocation for private sector investment. Due to raw material shortages there was substantial idle capacity in industry. Though terms of trade deterioration was one of the major factors, the balance of payments problem can be largely attributed to the deficit government budgets and unwarranted monetary expansion. A food shortage developed in 1956 to add to her problems. In 1955 there were no food grain imports of any significance into Pakistan, but in 1956 it was 20 per cent of total imports, while in the subsequent year it rose to 26 per cent. Food grain distribution was controlled by the Government and its activities were financed by resorting to deficit financing. The resulting inflation and excess demand forces operating at that time, together with a large leakage of foreign exchange through unofficial channels, aggravated the situation. Investment growth was checked by the scarcity of foreign exchange; the high import co-efficient on investment added to these difficulties. The large subsistence sector prevented the build-up of marketable surplus in food grains to meet the growing needs of population growth and urbanization. Import substitution programmes pursued upto 1955 had created a large demand for foreign exchange to finance maintenance imports. The claims on foreign exchange were far in excess of supply. The authorities clamped down severe import and exchange controls until a Bonus Voucher segment was added to the foreign exchange market in 1959.

For reasons already mentioned, devaluation, to correct the imbalance in the foreign payments position, had been ruled out in both Pakistan and Sri Lanka. However, the events that led to the Indian devaluation in 1966 were somewhat similar to those

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prevailing in the other two countries. But it should not be forgotten that unlike the other two countries India had achieved structural changes in its import, export and domestic expansion. Devalution, therefore, was expected to give the necessary boost to export growth of industry whose foundation had been laid over the past.

Indian prices were rising faster than those of her trading partners. Between 1960 and 1965, wholesale prices rose 15 per cent in U. K., 2 per cent in U. S. A., and 2 per cent in Japan, while wholesale prices rose by 31 per cent in India. India's imports showed a continuously rising trend and throughout the period 1960-65 it had an import surplus. While imports increased exports declined relative to total domestic output. Exports were subsidised and heavy restrictions were imposed on imports. As the development programme gathered momentum imports of capital goods and maintenance imports increased. Exports on the other hand remained sticky and India's share in world exports declined from about 1.5 per cent in 1960 to about 1 per cent in 1965. The internal price level showed an upward trend, rising by nearly 80 per cent between 1955 and 1965. A rapid increase in money supply by over 100 per cent relative to an increase in output of 40 per cent was the main contributing factor to the increase in prices. Due to these plurality of causes the devaluation of the Indian rupee by 36.5% was considered unavoidable. India also had to safeguard against a retaliation from Pakistan and Sri Lanka. The demand for jute and tea are inelastic and gains from devaluation would, therefore, rise if the foreign buyer substitutes cheaper Indian jute for that of Pakistan and cheaper Indian tea for Ceylon tea. Pakistan, in fact, was considering the liberalisation of the Bonus Voucher rate. But India clamped an export duty on jute and tea, thus discouraging the adoption of retaliatory devaluation measures by Sri Lanka and Pakistan.

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After the devaluation export duties on twelve items were raised; imports were liberalised. However, import controls were not relaxed nor were tariffs lowered. Monetary policy lagged behind. Though capital was scarce, rates of interest remained low. This paradox has been made possible by two policy devices.[1] Firstly, "selective and discretionary controls are exercised" in granting credit. Secondly, "exchange controls and a great number of discretionary negative controls.........................are used to limit production and investment". However, devaluation was supported by fiscal and monetary measures that aimed at curbing private consumption and increasing the rate of savings. In 1966/67 there was an expansionary deficit of Rs. 3.06 billion and in 1968/69 it was reduced to 2.90 billion. The size of the deficit did not cause concern since restraint has been observed in budgetary expenditures. Admittedly, any further resource mobilisation to finance the deficit would have hurt industrial recovery and postponed the general economic recovery through the balance of payments.

Liberalisation of imports was mainly confined to a liberal licensing policy. In addition import licensing has been directly linked to consumption of imported commodities and the entire policy was directed towards providing adequate protection to growing domestic industries whilst conserving foreign exchange resources.

The Indian devaluation was more helpful in getting rid of the numerous administrative controls than pushing India towards a gradual policy of liberalisation. Even at the end of 1967 the gold and foreign exchange reserves were below the level of 1960. India, therefore, had to follow a more cautious policy conditioned by fear that a large volume of reserves will fall if large scale

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1. Gunar Myrdal : Asian Drama, Vol. III, page 2089.

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liberalisation took place. Therefore, liberalisation of imports was confined mostly to raw material imports in order to feed the growing industries. The post-devaluation policy was continued in its basic features so that licences for imports of industrial raw materials, spares and components were given on a liberal basis. This included the granting of licences on a continuing basis for 59 industries covering 85 per cent of industrial output. For other industries, the facility for automatic renewal of licences was not granted. The policy of restricting or banning the importation of locally produced goods was continued and extended. This relatively liberalised policy led to a rise of nearly 6 per cent in imports in 1970/71, both as a result of a rise in industrial investment and output of import competing industries and an expansion of export industries.

Considering the favourable treatment of export oriented industries it was not surprising that there was a tendency for the growth of inefficient high cost ventures. In fact, some industries benefitting from this policy charged high prices in the locally protected market; in some cases the local product was found to be unsuitable for certain end uses. Accordingly, price and quality of domestic supplies were taken into consideration in restricting or banning a certain item.

Indian liberalisation was a slow process despite a rise in foreign exchange reserves. In 1969/70 the import licensing policy was rather restrictive. Import licences were issued according to actual past consumption of imports. This scheme has resulted in domestic shortages due to licensing delays. The fear of possible difficulties in the future in the balance of payments, emphasise the need for continuing these controls. Otherwise Indian economic recovery would have called for fair degree of liberalisation of imports and exchange control measures.

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Exports rose by 13 per cent in 1968 while in 1969 it rose by nearly 5 per cent. The foreign exchange reserves showed a welcome improvement. Foreign aid receipts together with the reduced imports resulted in building up of reserves by $ 254 million between 1968 and 1970 after meeting an IMF repayment commitment of $ 245 million. The volume of reserves, it was estimated, was nearly 40 per cent of the imports for 1969/70, while in 1971 it was around 45 per cent of expected imports in the following year. Preliminary estimates of the balance of payments for 1970/71 indicate that India may end up with a surplus of nearly $ 100 million (excluding SDR allocations) Exports are expected to grow at 6.5 per cent, while imports will grow by 9 per cent in 1971/72. An achievement of these rates of growth presupposes the continuation of liberal policies in respect of imports. Accumulation of foreign exchange reserves can turn out to be a luxury if they are idle. The reserves seem to be adequate to allow greater use to service the expanding export industries with raw materials and spares. Though the reserves were relatively high, India followed a cautious policy of liberalisation. In the wake of rising prices due to scarcities and a high rate of credit expansion a cautious policy on imports is understandable.

Pakistan embarked on its liberalisation scheme in 1959 with the introduction of the Bonus Voucher Scheme.[1] On the export side, all goods except five major commodities - jute, cotton, wood, hides and skins and tea - that enjoyed good markets abroad were given incentives in the form of bonus vouchers. From time to time it was modified or expanded in accordance with the needs of changing requirements. This scheme led to a complex system of multiple exchange rates as the bonus rate differed according to the commodities. The acquisition of bonus vouchers gave the holder

1. Rashid Ahamad - Export Incentives and Export Bonus Scheme

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a claim to an import licence of an equivalent face value to import from a list of eligible goods.[1] These vouchers are marketable and the holders reaped windfall profits. This also led to fluctuating exchange rates, mainly because of the wide differences on the selling side. On the import side, the bonus rate went upto 150 per cent above the official rate. It should be remembered that the bonus rate for different types of exports and imports varied from time to time. As to be expected a certain amount of confusion arose at the beginning and attempts were made to get the more favourable rate for certain commodities by classifying them under different names or categories to take advantage of the borderline nature of the classifications.

Evidently, the aim of the bonus voucher scheme was to boost non-traditional exports, whilst providing some degree of liberalisation for non-essential imports. The number of commodities under the list was about 244. Though the importers were entitled[2] to import licences on the production of bonus vouchers, in effect, quotas were imposed on such items like cars. There were also controls about the direction of imports as between the two wings, while several were allowed to be imported by the industrial users only.

In 1967 another rate was established through a cash-cum-bonus procedure. A cash-cum-bonus list was drawn up and importers from this list had to submit bonus vouchers equivalent to 50 per cent of the face value. The new procedure was expected to be a better price machanism for allocating imports. Most of the intermediate goods (except aid imports and those contracted under bilateral agreements) were on the cash-cum-bonus list.

1. Frant C. Child - Liberalisation of the Foreign Exchange Market and Pakistan Development Review. September, 1968
2. Importers had to pay for imports at the official rate together with Bonus Vouchers equal in face value to the local currency cost at the official rate of imports.

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Capital goods continued to be imported under the official rate but with high duties. But this procedure resulted in building up of capacities that could not be regularly supplied with materials and spares due to the shortage of foreign exchange.

The adoption of the cash-cum-bonus system was one way of rationalising the exchange system. This indicated that Pakistan was willing to move towards a unification of the exchange system. It was noted that the bonus voucher system gave rise to a multiplicity of rates. Since these bonus vouchers were traded at the Karachi Stock Exchange its market price varied considerably within a short period. In 1970, the market price fluctuated between 170 and 180 per cent of its face value. The cash-cum-bonus system was a step forward in the direction of liberalisation, but difficulties of a further rationalisation arose from the large volume of tied aid. There were many difficulties of merging the aid goods market with the general market, as it was not possible to have a unified bonus voucher price since it would have created large differences between various types of aid. There was misallocation of resources and a build-up of excess capacity. Import restrictions remained heavy. The problem of tied aid was a real one. Imports under tied aid were generally priced higher than those got from other sources. In order to absorb this type of aid, Pakistan allowed them to come in at an appreciated rate. Capital goods that came under aid, posed another problem as spares and raw materials could not be allowed to come in freely in order to keep them in production at full capacity.

By 1970 Pakistan was experiencing severe external resource problems. In addition to a short fall in external assistance during the period of the Third Plan (1965-70) there was a decline in export earnings. The debt servicing burden also rose. Though imports declined, partly because of a good harvest and partly

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because of the slow-down of business activity; the inadequacy of the exchange policy pushed the authorities into tightening restrictions on trade and payments. Although the monetary and fiscal measures were co-ordinated, little attempt has been made to contain the inflationary pressures. Wage increases have been granted to both public and private sector employees.

On top of these inflationary pressures, Pakistan maintained a system of multiple rates that tended to distort the cost/price structure. Though the authorities were aware of the need for a basic reform of the exchange system, it was not until June, 1972 that she moved towards the unification of the rate when Pakistan devalued by 60.13%.

Thailand

The Japanese occupation of Thailand compelled the adoption of deficit financing to meet Japanese war expenditure in Thailand. By the end of the war in 1945 currency in circulation had increased to 1993 million Bahts from a mere 296 million Bahts in 1942. There was a severe shortage of goods and materials consequent to the war. Invariably the rise in the currency in circulation resulted in prices going up at a very fast rate. The official cost of living index rose from 177 in 1942 to 1,070 in 1945. Adequate monetary and fiscal policies could not be adopted because of the peculiar situation arising from the occupation. This meant that the growing inflationary situation resulted in bringing about hyper-inflation where prices rose over 200 per cent in one year. The inability to maintain price stability and stability in monetary and fiscal matters during the war emphasised the need for the maintenance of monetary and price stability soon after the Japanese occupational forces left the country. There was indeed a big strain on the economy, as well as on the mangement capacity and ability of its officials, as a result of the occupation. At best, the monetary authorities

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could adopt ad-hoc measures to obtain maximum benefits or to minimise any harmful effects on the economy.

Soon after the war the Thai Government was faced with a number of problems. It had very low reserves and was unable to undertake any stabilisation policy in its international front except by resorting to drastic measures. The Thai Government also had to supply a certain volume of rice to the allies free of charge as a kind of reparation payment. Rehabilitation and reconstruction that had to take place soon after the war were very expensive. Over-riding all these were the inflationary pressures which had gathered momentum, mainly because of the high level of deficit financing undertaken during the war period. As a temporary stop gap measure, trade and exchange control were introduced but the Baht continued to be over-valued. Imports were restricted to necessities and some capital goods that were required for consumption and for rehabilitation. Hoardings which acted as a further threat to inflation were discouraged when 1000 baht notes were de-monetised and withdrawn from circulation. Gold reserves held in U. S. A. were used to purchase urgent imports. All these measures were taken to reduce the inflationary pressures that were gathering momentum.

In 1946 trade and exchange control regulations were introduced and subsequently tightened. However, this proved inadequate to meet the constant drain on reserves which resulted from the over-valuation of the Baht. Invariably there was a large net outflow of foreign exchange. The large difference between the black-market rate and the official rate led to large scale smuggling. The time was inappropriate for the unification of the rate, Both political and economic factors stood against a possible unification. Instead, Thailand introduced a multiple exchange rate system. This was mainly aimed at expanding

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exports and curtailing imports. The official rate was fixed at 40 Bahts to the pound Sterling while the free market rate fluctuated around 60 Bahts to the pound Sterling. The rate was used to permit the increased export of certain products. In the case of rice and cement exports, full proceeds were to be surrendered at the official rate. In the case of imports, the free market rate applied to all approved imports except those approved by the Bank of Thailand for specified purposes. All government imports were at the official rate. Importers had to purchase their export requirements from the free market. The Bank of Thailand also released some exchange for scheduled imports but at the free rate. There were certain unspecified imports that were permitted.

These exchange reforms had immediate favourable effects. They siphoned off the excess income, thus reducing the spending power of the consumers. The large leakages of income into imports was also reduced, thus curtailing imports.

This system worked well between 1947 and 1951. However after the crash of the Korean boom in 1952 the economic situation changed and remained adverse to Thailand. The export earnings from rubber and tin declined very sharply and the rice sales dropped to low levels. Imports that had risen due to boom conditions in 1950 and 1951 did not decline with the fall in export earnings. The reserves fell sharply; government revenue also fell. Accordingly, the government resorted to deficit financing and nearly 1500 million Bahts per annum were put back to the economy between 1952 and 1954. With this heavy stress and strain on government finance and export earnings, the multiple rate system, which also provided a part of government revenue, could not function properly because of the growing imbalances in the balance of payments. In 1955 the multiple exchange rate system was given up and the exchange rate was unified. Since this unification Thailand's exchange rate remained very stable throughout

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the year. A parity rate at 22.83 Bahts per U. S. dollar was established with the I. M. F. in 1963 and the free market exchange rate remained at that level ever since (except for minor fluctuations) Thailand did not devalue when the pound Sterling was devalued in 1967. This meant that the Thai currency remained over-valued against the Sterling. During the period of currency realignments in 1971 and the subsequent devaluation of the dollar, Thailand remained with the dollar thus causing an effective devaluation with the pound Sterling.

Indonesia

The persistent current deficits in the balance of payments since 1960 together with a high rate of inflation and an over-valued exchange rate caused a sharp decline in the confidence in the Rupiah. More and more controls were imposed prior to import controls but all these merely aggravated the problem.

The export performance was rather poor. Inflation, lack of modernisation of existing plant and equipment, difficulties in transportation, inelasticity of supply of export products and the severe exchange regulations all affected the growth in exports adversely. In fact, as the exporters were given the official rate of exchange they preferred to sell the exports in the unofficial market and profit by the difference between rates.

All these led to a rapid fall in the exchange reserves from U. S. $ 259.9 million in 1959 to U. S. $ 8.6 million in 1965. The position deteriorated further and between the third quarter of 1966 and the second quarter of 1967, the foreign exchange assets of Bank Indonesia showed negative balances. The foreign exchange liabilities increased from Rp 37 million to Rp 597 million. Debt position was extremely high and most of it (43 per cent) was

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incurred to support the armed forces. At the beginning of 1966 the foreign debt was U. S. $ 2500 million.

It was in this atmosphere of exchange difficulties that Indonesia launched its bold programme of exchange stabilisation. On 3rd October 1966 the Bonus Export System (generally known as BE system) was introduced to improve the balance of payments position by encouraging exports. In addition to encouraging exports it sought to rationalise the use of foreign exchange and to increase the revenue of the government through this foreign exchange tax. It was also intended to give some type of protection to goods produced at home for domestic use and for exports.

In 1966 the Rupiah was over-valued at 0.25 Rupiah per U. S. dollar at which no transactions took place. An effective rate resulted from a surcharge of Rp 9.75. Thus at the rate of Rp 10.00 per U. S. dollar the exporters had to surrender a part of their proceeds (50 per cent) and were free to dispose of the rest under the Bonus Export Certificate scheme. The BE certificates could either be sold to importers at the BE market or utilised for the import of commodities. Proceeds surpassing the fixed price, which was commonly known as the 'check price' may be held abroad and could be freely disposed of. In order to encourage the exchange above the check price a DP market (a complimentary exchange market) was opened. The mixture of official rate and fluctuating rate resulted in various effective rates. Payments for certain invisibles for government imports and for aid imports were effected at a fixed rate (aid import rate) of Rp 85 per U. S. dollar at which Bank Indonesia purchased BE certificates. A major revision of exchange rate system took place in 1967. The official rate of Rp 10 was abolished. A free exchage market was opened at the Djakarta Bourse composed of members of Djakarta Stock Exchange and the Foreign Exchange Banks.

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Under this system exports were broadly divided into A and B categories. Catagory A consisted of major exports of 9 major commodities other than oil. The check price for exports was determined by the Ministry of Trade and it was fixed at a level below the world market price so that the exporter may have a margin above the check price for himself in the form of an "over price". The exporter surrendered the exchange earnings after paying an exchange tax of 15 per cent of which 10 per cent is allotted to regional authorities for development projects, while the remaining 5 per cent accrued to Central Government as an export tax. Money realised from the over price may be freely disposed of abroad or in the DP market in Djakarta.

The goods in category B exports were minor exports (other than timber, which was becoming a major export and treated that way) and the price declared by the exporter was accepted as the surrender value. The exporter received 90 per cent of the declared price in local currency for the amount of foreign exchange surrendered. There was no export duty on them, but the 10 per cent regional tax had to be paid.

The foreign exchange obtained from the "over price" proceeds of A and B category goods may be held abroad or fed into the free market in Djakarta. The free market supply of such exchange was termed supplementary foreign exchange (or D.P.).[1] No permission was required to have a supplementary foreign exchange account in Indonesia or abroad.

Imports were financed by BE receipts, credit BE permitting use of aid and credits received and DP receipts. Imports were classified into 4 categories depending on the essential nature of the commodity. Imports under A and B categories were to be

1. Petroleum rate is different and is fixed each month by the Ministry of Finance to conform to movements of the BE rate in the previous month.

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financed through resources generated by general BE (exports) and special BE (aid and foreign credit) receipts. Since May, 1968 the BE and credit BE rates were unified and one rate was applicable to both. All goods under category D had to be imported with DP exchange. DP exchange, however, could be used to import any item in any one of the four categories. All demand for foreign exchange was channelled through the exchange Banks. Central Bank reported to the exchange banks the daily position so that allocations could be made under BE or credit BE sales. Central Bank scrutinized the import list under the four categories regularly.

Speculation in foreign exchange took place at the beginning mainly because of inflation. Gold and commodities were imported mainly as a hedge against inflation and this practice added fuel to the inflationary situation in 1966. In order to stabilise the exchange rate Central Bank intervened at the height of the crisis by open market sales of dollars from its scanty reserves. The validity of BE certificates was reduced from 3 to 2 months, then to 3 weeks and finally to 10 days, during which period letters of credit had to be opened. All unutilized certificates had to be sold to the Central Bank at penal rate of 265 rupiahs per dollar. Gold bullion was removed from the list of essential commodities. At the time letters of credit were opened a 100% margin was required against foreign exchange demanded. Subsequently, two modifications were made to the working of the system. All BE certificates had to be sold to exchange banks which in turn put them to the market immediately and proceeds given to the exporter. The BE general and credit BE rates were unified.

In June 1968 there was an extreme shortage of foreign exchange and this was alleviated by aid receipts from Japan and U.S.A. To avoid panic and speculation the exchange market was temporarily suspended for two sessions. With aid receipts this

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atmosphere of panic and speculation subsided and confidence was restored. Central Bank interfered in the DP market by buying BE exchange and selling in the DP market.

Some kind of stability has been achieved in the foreign exchange market. During 1969 the foreign exchange situation looked good. There was a carry over of nearly U. S. $ 400 million credit from 1968. The high interest rate has attracted funds from abroad and the supply of funds had exceeded the demand. In the BE market supply exceeded demand by U. S. $ 756,000 in the month of April itself. Similarly, in the DP market supply was in excess of demand.

The increasing confidence in the Indonesian Rupiah has been reflected in the foreign exchange market. Since October 1968 the depreciation of Rupiah exchange rate has been arrested and reversed. The I.M.F. had not established a par value for the Indonesian Rupiah but the pressure was being applied by the I. M. F. towards a unification of the exchange rate. In the meantime the demand for BE had decreased and the availability of aid BE had increased. BE credit given by donor countries were allowed to be sold at a slightly lower rate than the DP rate by the donor countries for the purpose of financing essential imports. Similarly, excess of supply over demand at going rates has appeared since late January 1969 in markets for DP and other free foreign exchange which sell at a premium over BE because of lack of restriction on their use. In both the DP and BE markets the Indonesian Central Bank had retained the excess supply amounting to nearly 30 billion dollars which had been netted since November 1968 while at the same time propping up both rates. The BE rate which had risen about 270% between December 1966 and October 1968 has since been stabilized at 326 rupiahs per dollar. The free market DP rate climbed to a new high in October to 495 but slowly climbed to 377 by January 1968. As at January

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1968 the spread between the two rates had been about 10.2%. The fluctuations in exchange rates had thus been kept to a minimum and stability has been achieved within 10% of the spread. The progress towards stability and confidence in the rupiah was spurred by Indonesia's bumper harvest of 1968 of 10.7 million tons or 14 per cent over the 1967 harvest.

Gross Indonesian exports in 1968, led by an estimated increase of 20 per cent in the oil sector, grew about 12 per cent. Official capital inflow had also been a factor that had enabled Indonesia to achieve a high degree of stability. Indonesian Government policy had played a key role, increasing utilisation of aid BE whose available monthly rate of sales rose from 7.7 million dollars before October to about 10 million dollars. A dip in demand for general BE during November and December stemmed partly from Government's successful stabilisation policy including credit tightening in respect of imports in non-productive sectors.

In October 1968 the State Banks started to support the development programme by attracting deposits with positive rates of interest of 4% to 6% per month (higher than the rise in the price level by about 2%). It was the policy of the Government to keep the rates positive and as the price level gets stabilised this rate will be kept at least about 1% above the price level.

In February 1969 a lottery savings programme paying 2½% to 3½% interest was also introduced. During October 1968 to January 1969 much of the foreign exchange acquired by the Central Bank in the BE market was injected to the DP market reversing the trend in the DP rate, dampening currency regulations and providing the necessary conditions to import popular non-essential goods with which to help satisfy a large backlog of demand. As added insurance against inflationary price levels

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imports of textiles, sugar, salted fish, were imported by the Government when their prices rose in the domestic market. In late January 1969 the domestic capital investment law, which exempted certain time deposits from investigation as to source and from taxation, was brought into force. By late January 1969 it seemed clear that prices of most consumer goods and exchange rates in the foreign exchange market and BE market could be held relatively stable even during the season of maximum pressure from consumer demand.

The sharp decline of private demand for DP in January may have reflected the financial stability of speculative expectations in regard to the prices of non-essential imports and rates of foreign exchange. The subsequent foreign exchange inflow has been paralleled by an accelerated growth of time deposits. In February 1969 these deposits reached 10 billion rupiahs-reflecting the original target for June 1969. Demand deposit interest rate decreased from 12% to 8% at private banks and the rupiah appreciated 18% in relation to gold from mid-January to mid-February. The money supply declined in January by 4 billion rupiahs and for the first time in years Djakarta merchants have lowered some retail prices, by as much as 50%, mainly on imported goods such as textiles and some importers have even granted consumer credit. These month to month movements are indicative of the gain in confidence in the rupiah.

Indonesia's Five Year Plan established a frame for growth and it will inject a sizeable governmental financial expenditure into the income stream and place great demands upon Indonesia's already starved supply of service, technical and managerial power. It was noted that the 1968 harvest depended heavily on the favourable weather conditions. A poor harvest would therefore lead to inflationary pressures especially if price of rice increased as a result of poor harvest; the index had a weight-

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age of 31% in the overall group for rice and the payment of wages for all government servants were partly in rice.

As the short term export outlook seemed unclear export taxes were lowered (since the world rubber prices were rising) to enable Indonesia to catch up in the export market. But a smaller tax was imposed on certain export goods since demand dropped in the DP rate it reduced the average export earnings by about 4%. The problem of re-directing incentives is a long term one. Various attempts have been made with a view to terminating smuggling and to abolish certain irregularities made by certain regional authorities and to exclude military operations from tariffs.

One of the major draw-backs of the Indonesian man power structure is that the absorptive capacity of people in different branches of government and business enterprises remained very low and had not kept pace with the growth in institutions. Having got used to a plethora of central control, decentralisation would require well trained and a class of people highly devoted to work.

Indonesia's development programme was particularly hampered by the legacies of the past and the subsequent acute inflation and partly by the side effects of stabilisation programmes. The accumulation of time deposits may have slowed down business activity. The foreign exchange reforms have had their share o success and exports increased by nearly 15% over a three year period. Exports would have risen by a higher amount if not for the administrative obstacles. Exports had to undergo changes perpetuated under official channels. Because of the inadequacy and deterioration of infra-structure, costs of exports had risen thus resulting in a fall in the rate of growth of export values.

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Success of the scheme was also dependent on the capital inflow which was fairly substantial. In 1968 alone there was a consortium aid amounting to 390 million dollars consisting of 275 million BE credit, 40 million food aid and 75 million project aid. Of this 265 million was drawn in 1968. Taxes from oil production rose by more than 50 per cent as a result of the increase in oil production by 20% in 1966/67. Debts of Indonesia to the U. S. and other western countries were rescheduled in 1966/67.

Indonesia has vast potentialities in mining and forestry. About 275 million dollars of foreign capital is expected to be invested in these ventures, but due to the low absorptive capacity of the Indonesian investors, caused mainly by the social structure, the foreign private investments that enter into Indonesia is in small proportions of nearly 15 million a year in 1967/68. In 1969, at the consortium meeting, Indonesia wanted nearly 500 million dollars worth of aid, consisting of $365 million programme and project assistance, and $135 million for food. About 59% of total investment in the five year plan consist of foreign aid, averaging 555 million per year and exceeding 700 million dollars in 1973. Private capital inflow was scheduled to account for 14% of investment financing and to average 115 million dollars per year. The U. S. contributions have increased in recent years and a total 2.78 billion dollar aid may flow into Indonesia in the five year period (1970-75). Long term Indonesian plans call for an increasing proportion of Indonesian imports to be financed by foreign aid, assuming that this aid materialise in projected amounts. Food imports and an estimated $167 million in 1969 are scheduled to flow in 1973. Imports of fertilizer and cotton are to be in an annual range of 140 to 180 million dollars. Capital good imports are projected to rise from 275 million in 1969 to 614 million in 1973. The market for non-essential goods in Indonesia is very small. The fact that there

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had been a build-up of reserves as a result of the foreign exchange market is enough evidence that the policies adopted by Indonesia had paid dividends.

In fact the demand for foreign exchange has fallen below supply mainly as a result of more foreign funds, some of which, are in the form of hot money, come in to take advantage of the high rate of interest offered by Indonesian State banks.

The bold moves by Indonesia to adopt a free rate of exchange at the time of the foreign exchange crisis was not without any costs. As the rate of exchange between the BE and DP markets fluctuated widely, speculation became rife and this resulted in a panic in the DP market. This resulted in the adoption of discriminatory measures against imports from Hongkong and Singapore which were on contract and short term credit had to be paid for immediately.

In order to prevent a serious breakdown in the confidence an assurance was given by the Minister of Trade that the BE would continue to be available to enable importers to honour their commitments entered into for shipments from Hongkong and Singapore. He also gave the assurance that this crisis would be temporary and all such controls introduced during the crisis would be lifted soon. Accordingly, in keeping with the promise that was given to the importers, it was subsequently lifted. These measures which were restrictive in character had a favourable effect on the economy in general and on import payments in particular.

It was reported that the restrictive use of BE had helped Indonesia to build up a reserve of 70 billion dollars which were freely convertible and of this amount 40 million dollars were used to pay off foreign credit. The practice was to import goods on BE from donor countries, thus discriminating against

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others, such as Germany and the Netherlands, who were prompt in coming to Indonesia's aid in the early months of 1968. The adoption of discriminatory trade practices among member countries was unfavourably viewed by I. M. F. as it was unhappy that there should be some type of discrimination against its own members. The exporters from other countries were unhappy that they were unable to sell to Indonesia and the importers themselves were in a quandary as they were unable to gauge the foreign exchange transactions situation as it changed every week depending on the BE aid credit of the donor countries.

One fundamental change in all this exercise is the heavy reliance on market forces in the allocation of scarce resources. The gradual de-centralisation and de-bureaucratization has resulted in the growth of institutions which are able to carry through effectively the monetary and fiscal measures adopted by the Government. Exchange reforms have to be accompanied by monetary and fiscal measures and the success of one would give the right psychology for the success of the other. Thus, the de-control of prices was a tremendous success and accompanied by bumper rice harvest it resulted in a tremendous fall in the living index. Though the living index may not portray the actual economic conditions with regard to the price level, the propaganda done was such that the business people came to realise that the index was an adequate indicator of the movement of prices. Accordingly, the business psychology tempered down towards stability.

The incentives given to residents and non-residents to bring in foreign exchange and allowing free market forces to determine the price of exchange required for non-essential imports changed the economic structure from one of a lack of clear-cut economic policy and severe controls to one of purposeful planning.

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However, it should be noted that between 1966 and 1970 the Central Bank interfered in the market with the aim of stabilising the currency. The ultimate result was that the over-valuation of the currency dropped and the rate moved towards the free market rate.

At this time there were six different rates. The major import and aid import rates moved very close to each other. There were divergences between major export and major import rates.

The exchange rate was unified by April 1970. A single exchange rate at rupiahs 378 per dollar was established and the rupiah was freely convertible. However, imports financed from aid imports continued at Rp. 326 per U. S. dollar. All import and export procedures were simplified. The improvement in the balance of payments position enabled the unlimited convertibility of the rupiah. The rupiah was devalued in 1971 soon after the U. S. dollar was floated and the exchange rate was fixed at 415 rupiahs to the dollar.

Conclusion

Sri Lanka, India and Pakistan followed somewhat similar policies on the exchange front for a number of years. As indicated in previous pages, the Indian approach was less cumbersome than that of Pakistan or Sri Lanka. Sri Lanka, particularly, got involved with welfare measures that the country could not afford. Instead of encouraging the people to cut down consumption it created more money without creating resources. Pakistan, though not involved with welfare measures to the same extent as Sri Lanka, experienced a high deficit in government fiscal operations, mainly because of shortfalls in taxation and a high defence budget. When the time came for an exchange rate adjustment it was possible to postpone the issue because of the availability of foreign aid.

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In the case of the Indian devaluation of 1966, initially it was ineffective in expanding exports immediately. At the beginning of 1967 it looked as if the Indian devaluation was a failure. Black-market for foreign currency remained almost unchanged. The imposition of export duties to prevent competitive devaluation by Sri Lanka and Pakistan nullified the beneficial effects of devaluation. Prices rose faster than in the pre-devaluation year. Food prices rose by 30 per cent in 1967 (October) over that of the previous year, while all commodities showed a price increase of 16 per cent over the same period. The timing of the devaluation was considered unfortunate, in that it was weakened by bad harvests. However, the subsequent comfortable food grain supply in 1968 together with an expansion of non-traditional exports supported by monetary and fiscal policies enabled India to recover from the serious disequilibrating effects of the balance of payments. Thus by 1970/71, the effects of devaluation began to be felt. Between 1966 and 1970 exports rose by nearly 26 per cent while imports declined by 11 per cent. The emerging pattern of industrialisation consciously pursued in the past supported this economic recovery; it was further assisted by effective controls over aggregate demand.

On the other hand, Sri Lanka and Pakistan failed to control aggregate demand. It was, therefore, natural that the price sensitive current transactions would not respond effectively to half hearted measures of liberalisation without bringing domestic over-heating under control

When domestic costs remain out of alignment with international prices in consequence of price distortions, it is necessary to approach the problem by adjusting the exchange rate. This has to be supplemented by monetary and fiscal measures. What Sri Lanka did in 1967 or India did in 1966 were not fully conducive to the achievement of equilibrium in the balance of payments. Sri Lanka increased the welfare measures by giving one measure of rice free

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to all consumers to avoid possible political disturbances. In addition, the aims of devalution were immediately nullified by granting wage increases and devaluation allowances Considering the fact that Sri Lanka devalued only by 7½ per cent against Sterling it was apparent that both the size of the devaluation against her major trading partner and the supporting measures confined only to credit restriction were hardly adequate to correct an imbalance of such a serious nature as that had developed since 1957.

A change in the par value was carefully avoided, not only because of the lack of clear understanding of the timing of the change with the appearance of clear signs of a fundamental disequilibrium, but also because of its immediate price effects. Since a fundamental disequilibrium was not confined to balance of payments alone, it was not possible to identify early warning signals in the form of severe distortions in relative prices and changes in the structure of demand for exports. The Indian devaluation of 1966 may not have been well timed because of the bad harvests, but it succeeded in boosting its non-traditional exports at a time when the demand for its major exports were indicating major structural shifts. The Indian situation was different from that of Sri Lanka and Pakistan. In these two countries internal factors did not favour an across the board devaluation. Furthermore, plethora of controls had a tendency to hide the early warning signals. On top of these, the political and phychological constraints worked against an exchange rate adjustment. Invariably these were supported by the cost of living argument. One way of compromising under the existing circumstances was to adopt a system of multiple rates so as to minimise the cost of living effects.

Economically, a system of multiple rates could produce favourable effects on the balance of payments. It would also have a selective effect on prices of certain types of goods rather than producing pervasive price effects. On the export side, the increased profitabi-

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lity would reduce what is available for home consumption and thus increase export availability. Multiple rates are also expected to produce the least amount of ill effects on output and distribution of income, while the employment effects could be favourable. On the other hand, a unitary devaluation would result in the distribution of income being more unequal whilst causing a decline in real income and pressure for an upward adjustment in wages. Politically it is more acceptable. Even if a unitary rate is adopted the controls will still exist because of the fear of pushing up the cost of living.

Pakistan's bonus voucher scheme, was in effect a multiple currency practice introduced in order to expand exports and reduce imports. It was noted that the bonus voucher scheme resulted in a rapid expansion of bonus exports. In a matter of four years bonus exports rose by nearly 150 per cent. It stimulated industrial activity. What is generally not emphasised is its ill effects. There was a misallocation of resources, under-utilization of capacity and a general dissipation of foreign exchange, mainly due to the lack of discipline within a multiplicity of fluctuating rates. Investment decisions are generally based on expected future growth, expectations and possibility of reaping large profits. When two different types of goods required for the same industry are imported under two different rates, there is not only an element of confusion in costing but also mis-direction of investments that generally spring up without any regard to the factor endownments. These Pakistani industries operated under high cost conditions and under protection. In order to make them more viable, government was forced to adjust the bonus rate. This bred inefficiency, because very often the rate of subsidy rose inversely with the degree of efficiency or directly with inefficiency. On top of these no attempt was made towards rationalisation of costs. What actually happened was that the amount of the subsidy in the form of bonus vouchers was inversely related to costs. Meanwhile there were heavy uncertainties because of widely fluctuating bonus rates

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and frequent shifts of items from one category to another, often accompanied by adjustments in bonus rates. In addition, the rise in money supply, accentuated by budgetary indiscipline had ill-effects on the cost/price structure in the form of continuing inflation. Inevitably, the operation of multiple rates became ineffective in remedying the balance of payments crisis.

What we are concerned in this paper primarily is the need for a balance of payments policy in the drive towards full employment and economic growth. There is no way of pursuing full employment policies unless the monetary and fiscal policies are consistant with those of the balance of payments.

In the context of present world trends about liquidity and reserves it seems imperative that developing economies should not only accumulate a reasonable amount of reserves relative to imports, but also resort to development financing in order to achieve a high rate of economic growth.

The cautious policies pursued by India seem to have borne results. India has accumulated a comfortable level of reserves whilst accepting development financing.

Low reserves of Sri Lanka and Pakistan have forced them to borrow from outside. Invariably the terms and conditions of standy arrangements with the IMF require that these countries follow policies acceptable to the IMF. It is, therefore, contended with disdain that foreign institutions manage these economies. Furthermore, the large fluctuations in the earnings from primary commodities emphasise the need for a comfortable level of reserves.

The problem is to replenish the reserves, while attaining maximum rates of economic growth. The crises in the international monetary system has altered the fundamental character

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of the existing reserve system. In looking for a solution it is necessary not only to be guided by the problems encountered in the past, but also by the requirements of the future.

Before we discuss economic factors that influence policy decisions it is necessary to give a brief summary of non-economic factors that impede decision making.

The choice of a policy will depend on several non-economic factors. These environmental factors are very often more important than economic considerations. Of all the environmental factors the stability of the government and its appreciation of the need for clear cut economic programmes is one of the most important. It is true that democracies have been less successful than authoritarian governments. Countries of the latter type have been in deeper trouble than democracies. The success of the Korean and Indonesian policies were achieved only after the political leadership was able to give clear-cut directives on economic programmes. Pressure groups in Pakistan were more powerful than in India, thus enabling democratic India to adopt sounder economic policies to correct the balance of payments situation. Pressures from below to expand public welfare expenditures prevented Sri Lanka from choosing the right policy-mix with regard to monetary, fiscal and balance of payments matters.

Pressure groups in Sri Lanka are coloured by political parties thereby wielding power out of proportion to their size. Whenever there is even a temporary loss of real income, there had been resistance to government's anti-inflationary programmes. India's pressure groups, after several failures, coalesced with government measures. Lobbying in Pakistan was mainly by the upper income class, who wanted no change that would seriously affect their privileged position.

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Invariably when a government cannot carry through its programme of action it tends to implement piecemeal measures that may only affect a section of interests. In the context of existing rigidities, in practically every sector of the economy, these policies are bound to meet with little or no success. These are aggravated by concentration of ownership of new industries, as in most Southeast Asian countries, and the slow seepage of benefits arising from the "Green Revolution" to the lower income groups. Moreover, the 'conspicuous consumption' by the rich is weighted heavily towards imports. Apart from intensifying the balance of payments difficulties, this provokes the bulk of the poor either to work against all types of privileges or to increase the welfare programmes for their benefit.

Though the growth of an enterprising class of industrialists was not obstructed, it was slow to expand, because of the existence of various bottlenecks and controls. The existing financial institutions were improved, particularly in India, and their basis was made more growth oriented. In Sri Lanka and Pakistan modernisation and expansion of these financial institutions were somewhat slow. In as much as the existence of large semi-subsistence sector prevented a rapid expansion of the supporting institutions, so were the effects of monetary policy confined to a small section of the population.

Free education had been available in Sri Lanka since 1945. But the structure of education did not favour economic growth because of the imbalance between job opportunities and educational attainments. Because of the mis-matching of educational levels and attitudes towards available job opportunities there is a tendency for the unemployed youth to favour capital intensive industries. They will not work for less than a certain minimum income and in types of jobs acceptable to them. These attitudes are very common in Sri Lanka mainly because of relatively high real

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wages supported by subsidies in the form of free rice, free education and free medical facilities. Obviously, the constraints constituted by low savings and low import capacity are heightened by an inability of utilising existing supplies of labour to the best possible advantage despite 27 years of free education.

The non-economic factors enumerated above may be fragmentary but they throw light on the difficulties involved, especially in adopting measures that will yield results immediately. Macro-economic reasoning may be of considerable assistance in the choice of appropriate policies but the necessity to maintain certain political and social equilibria cannot be fully ignored.

The presence of these non-economic factors in varying degree in these countries has made it difficult to approach the problem in any clear cut manner. Accordingly, the corrective measures intended to put the economy on the correct path cannot be added in depth for fear of social and political upheavels. Thus, it is evident, the main problems of adjustment of the balance of payments situation are attributable to non-economic factors which have been responsible for deviation from the most appropriate course of section.

If we turn away from these and look for an alternative, economic factors present themselves. Though India has been able to achieve modest structural changes, Sri Lanka, Pakistan and Thailand are still grappling with the problems of diversification of their economies. This requires a very large investment of resources. Since world trading conditions are constantly changing this becomes all the more important. Before the competitive position is seriously impaired the problem has to be attacked from two fronts. On the one side, the exchange rate has to be changed and thereafter left flexible to suit the changing conditions. On the other side, the balance of payments con-

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straint must not be allowed to rule out the development efforts. To meet the gap in the balance of payments, a large volume of foreign aid has to flow in so that the maximum rates of economic growth can be realised within the shortest possible period.

There is no denying that foreign capital was one of the essential elements in the development of most countries. The United Kingdom was developed with capital brought in by immigrant settlers. Most European countries were developed in the same way. Russia's industrial base was built between 1880 and 1913 as a result of flow of capital from France. But subsequently she enforced savings on consumption but that was after the Bolshevik take-over. International assistance is vital for Sri Lanka or India or Pakistan to create better levels of employment, income and output.

The foreign exchange crisis has been one of the main causes for increased unemployment in Sri Lanka. The inability to import raw materials and spares has caused factory lay-offs. To meet the foreign exchange crisis Sri Lanka must necessarily obtain foreign loans and grants in order to assist her development programme and to enable her to keep employment at a certain level. These resources from abroad will have to be supplemented by other measures aimed at giving economic stability. However foreign aid has to be treated as a kind of first aid required to revive the economy so as to enable the country to achieve a higher level of employment income and output.

One of the important questions is the feasibility of adopting various alternatives and choices that are available in the matter of exchange rate adjustment in moving towards an equilibrium rate. No exchange rate policy will be successful unless there are supporting measures in the field of monetary, fiscal and income policies, both at the national level and at the international level.

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The concept of "fundamental disequilibrium" applies equally well to surplus countries as well as to deficit countries.

Most of the developing countries of Southeast Asia are deficit countries, a few of who are in "fundamental disequilibrium". It is understood that persistent deficits in the balance of payments are due to over-valuation of the exchange rate. All controls tend to protect an already over-valued rate; all controls tend to generate a mechanism for their continuance. But these restrictions seldom solve the problem; they only postpone the problem. By the time drastic action is considered necessary, the country would have lost a large volume of reserves.

In order to safeguard the reserves and use them for economic development, appropriate action has to be taken at the most opportune time. Timing of action is by far the most important. Exchange rate adjustments are no longer left to the determinants of free market forces in most Southeast Asian countries. Governments are compelled to interfere because of their political implications, especially in countries that follow social democratic policies. Is exchange rate policy alone helpful in remedying the imbalance? Under the well known methods the country in deficit must move towards equilibrium, either gradually, or by such devaluation as is necessary to correct the imbalance. In so far as exchange rates can be used to influence overall growth in the economy, the countries are not unwilling to follow the discipline required of such moves. But the general effects are not clear and when their effects are felt after a long period, they are often mixed up with other policies and the beneficial effect of exchange rate adjustments are often forgotten.

The achievement of economic objectives depends on mobilisation of resources as well as their allocation among different uses and their efficient utilisation. Most of the economies are

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mixed economies where free market forces are allowed to operate within a framework of government controls. In such a situation the economic planner has a difficult task to perform in influencing the prices of factors of production, in particular, and of resources, in general. But very little was done with the expressed aim of maximising the use of factors of production that were relatively cheap and abundant. Sri Lanka, Pakistan, India and Indonesia, all have an abundance of labour; scarcity of capital is accompanied by a shortage of foreign exchange resources. Planners have worked with good intentions to change the basic structure of the economy, but the structural break-down was slow and painful. In such a context dynamic measures cannot be pushed through to give quick results. Though priorities were set for sectors and for techniques of production that are labour intensive, so as to allow for a maximum utilisation of capital and foreign exchange, these were often neutralised and nullified by mis-directed policies.

Social control of market mechanism has been used too rigidly to avoid conflicts between profit maximisation and social welfare. But such policies have to be heavily backed by investment targets that are required for the expected structural changes. This has to be brought about bv appropriate pricing of resources. In devising overall policies to guide and regulate investment no attempt has been properly made to use effectively economic criteria that will provide economic growth in the long run. An immediate solution to the short-run problems was considered more important. Apart from keeping the price of foreign exchange low, supporting monetary and fiscal policies were not adopted so as to be effective. The main aim, of course, is rapid economic development. The exchange rate is one of the instruments that has to be used for this purpose.

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The entire exchange rate problem of the developing countries of Southeast Asia has to be tackled within the larger sphere of exchange rate adjustment and international monetary reform posed by the present crisis. Discussions for the solution of the present crisis have centered on five main points. One is the creation of adequate international liquidity to promote expansion of world trade. The second is the proposal for the adoption of a neutral asset to end the uncertainties arising from the heavy dependance on two national currencies. The third is the availability of a greater degree of flexibility in the exchange rate by the adoption of a wider band of fluctuations. The fourth is the acceptance by all countries to make more use of exchange rate adjustment to promote monetary stability. The fifth is the attainment of convertibility and the degree of that convertibility.

What needs to be emphasised here is that the developing countries must effectively participate in the search for an agreed solution to the present problems. Though the Group of 24 has been formed for such discussions, it has so far not exerted adequate pressure on the developed countries to incorporate the views of developing economies in any kind of reform of the international monetary system. Developing countries can no longer watch with indifference any attempt to change the existing structure of the world's monetary system without consultations and agreement.

The present system of parity adjustments leave developing economies, like Sri Lanka, with very little choice. Remedies that would work well in industrialised countries may not always be suitable to a country like Sri Lanka with a heavy dependance on a few major export commodities. Autarkic interests are still well imbeded in countries, thereby throwing a lower degree of confidence in the effectiveness of the contemplated actions relating to the exchange rate. These uncertainties together with a preponderance of non-

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economic factors prevent governments from getting involved in decisions that result in heavy political costs.

It was demonstrated in recent months that small adjustments in the exchange rate are more acceptable than wide changes that tend to cause a "psychological nausea" among all those affected. Thus during a period of adjustment a flexible rate is more acceptable as it would indicate the direction and the level of adjustment towards a more realistic level. When the imbalance caused by years of balance of payments deficit is large, a small change in exchange rate will hardly serve the purpose. But under a given political system, and in the absence of structural shifts, it would be difficult to attempt large changes in the exchange rate that would immediately disrupt the smooth working of the economic system.

When the IMF decided to have a system of fixed parities it was mainly concerned about avoiding uncertainties in the foreign exchange market that may affect trade and growth. The developing economies, similarly, would like to avoid uncertainties and a regime of fixed rates would be too rigid. There cannot be any degree of finality in the exchange rate market. By remaining fixed, the true value of the exchange rate cannot be ascertained. Very often the rate was more over-valued or under–valued than in equilibrium. Even if conditions remained the same in Sri Lanka, the rate could not be maintained in the wake of currency adjustments in the major trading partners. When the dollar was floated, the IMF had to impose a wider band for exchange transactions in a temporary regime of central rates. Since this wider band proved to be inadequate to take care of the adjustment needs of Sterling, a floating of the pound Sterling was considered a necessary prelude to the final adjustment. Thus, considering the troubles the advanced countries had in their re-adjustment process, which is still in a melting pot, it

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is not surprising that developing economies are unable to make quick decisions in this field.

The wider band around a fixed party can take care of cyclical disturbances, provided speculative flows do not disturb the reserves position seriously. Divergent monetary policies can also affect its working. Under conditions prevalent in some Southeast Asian countries, the adoption of a wider band is also inadequate. A crawling peg with a wider band will probably take the economy towards the equilibrium rate. What plagues most Southeast Asian countries is differing rates of inflation that places certain constraints on the use of monetary policy. A crawling peg with a wider bands can deal with this situation fairly well.[1] The developing countries cannot decide for themselves the maximum rate of crawl and the average period of the crawl.

This brings us to the question of the international character of the exchange rate adjustment. After the establishment of the IMF, exchange rates were fixed both by market forces and by negotiations. This dualistic character of the exchange rate adjustment, however, has not pervaded all international thinking so as to enable a clear adjustment of exchange rates in favour of economic growth and expansion of world trade.

The developed countries were more concerned about their internal policies and the external balance was considered secondary. However, it is well known that the external balance of the developed countries would impose certain disturbing factors on the developing economies. It could, therefore be difficult to isolate themselves from external imbalances and leave the primary producing countries exposed to the uncertainties attendant with international instability Therefore

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an element of consultation, which is already present in the Bretton Woods arrangement, has to be extended on a wider basis so that an orderly procedure can be drawn up. The scheme for international surveillance of the exchange rate movement, though implied in the Bretton Woods arrangement, was freely discussed and consciously adopted during the monetary crisis of the Seventies. At this time the Group of Ten got together and made various swap and other arrangements among themselves to enhance liquidity and convertibility of the major currencies. It is this type of consultation and negotiation on a wider basis that is required for international monetary integration. The developing countries must have their rightful place in such discussions.

The successful working of this type of parity adjustment, i.e. the crawling peg with wider bands, will permit economy in the use of reserves. It will also eliminate the possibility of making large and premature adjustments in the exchange rate. The experience with the system of wider margins is insufficient to assess the optimum volume of reserves required to act as working balances.

In a period of disequilibrating capital movements (as in Britain before it floated in June), it is difficult to appraise the adequacy of reserves. One suggestion that is made is to keep a separate account for currency transactions involving capital flows, It would then be possible to have, one rate for capital flows and another rate for all other transactions.. In practice it may be difficult to separate these two types of transactions. However, at present, some countries place cost restrictions on the inflow of short term capital. What is important is to put pressure on countries accumulating reserves so as to adopt discriminating practices against a massive inflow of short term capital. This problem, however, is not very grave in the develpoing economies.

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The developing countries have as their reserve the currency of major countries. The present instability cause further uncertainties that are heavily weighted against developing countries. But the bulk of the reserves are concentrated in a few developed countries. Of the total volume of 190 billion SDRs in reserve, only 18 per cent was in the hands of developing countries in December 1971. A large volume of reserves, beyond what is considered necessary, may be detrimental to expansion of world trade.

The growth and pattern of reserves have to be controlled by international action. If capital flows take place in order to take advantage of high rates of interests elsewhere, the countries receiving such captial flows should take adequate action to neutralise their effects by fiscal and other measures. International action may not be confined to exchange rates alone. Interest rate policy may also come under international surveillance.

The accumulation of a large volume of reserves by the developed countries is not very helpful in resolving the present crisis. A lack of balance in the development of countries has been one cause and perhaps the main one for the present imbalances. The share of world trade taken by the industrialised countries was 75 per cent in 1971, while the developing countries of Southeast Asia had only 5 per cent of the share. On the import side, the share of industrialised countries was 72 per cent, while that of developing economies of Southeast Asia was 6 per cent. In the case of reserves, these same developing countries held only 5 per cent of the world total as at December, 1971 compared to 77 per cent held by the industrialised countries. Conscious efforts have to be made to reduce this imbalance through programmes designed to favour developing countries rather than placing obstacles on trade flows from these countries.

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In this respect a question that needs to be answered is about the level of reserves required by a particular country over a certain period. In so far as short-term capital movements can be isolated they may be treated seperately. Reserves arising from other sources and concentrated in a few countries would add further constraints to international trade by the development of a system of suppliers credit and tied aid to help the deficit countries. It is, therefore, necessary to consider ways and means of siphoning off excess reserves by an international agency and pooling them for development purposes. This cannot be done through the IMF quota arrangement because the amount of excess reserves that may have to be placed in the pool may be out of proportion to the quotas. The developing countries can obtain loans from this pool on soft terms. Along-side this there may be a need to adjust parities of all currencies simultaneously so as to favour the developing countries. International assistance is better distributed through consultations and agreements than through policy directives from international agencies. Nevertheless the dual character of the adjustment process—market forces and negotiation—will have to be maintained and actively supported by all members.

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