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Macroeconomic
Policies, Crises,
and Growth in
Sri Lanka, 1969-90

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P R E M A C H A N D R A A T H U K O R A L A
S I S I R A J A Y A S U R I Y A

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Foreword

This volume is the product of a World Bank project on macroeconomic policy that reviewed the recent experience of eighteen countries as they attempted to maintain economic stability in the face of international price, interest rate, and demand shocks or domestic crises in the forms of investment booms and related budgetary problems. The project paid particular attention to the 1974–79 period (which included the first and second oil price shocks), the 1980–82 period of worldwide recession and external debt problems for many developing countries, and the 1983–90 period of adjustment to economic difficulties and the resumption of growth.

The objective of the project was to glean instructive lessons by analyzing the stabilization and adjustment policies pursued by these countries and assessing the outcomes. The authors of each country study were asked to deal with a common set of questions concerning the nature of the shocks or crises: their origin and degree of seriousness; the fiscal, monetary, exchange rate, and trade policies adopted in hopes of preventing permanent harm to the economy; and the results of the policies.

No single computable macroeconomic model was used in the project, but the framework of the open-economy macroeconomic model was followed to ensure consistency in generalizing about results. This intensive study of many episodes generated ideas and suggested relationships showing the causes and effect behind policies, the nature of the shocks and crises, and the governmental response to them. The overall findings of the project are presented in a synthesis volume by I. M. D. Little, Richard N. Cooper, W. Max Corden, and Sarath Rajapatirana, *Boom, Crisis, and Adjustment: The Macroeconomic Experience of Developing Countries*.

This study examines the macroeconomic policies of postindependence Sri Lanka, with emphasis on the management of shocks. In contrast to much of the literature on developing economies, which focuses on either long-term structural changes or short-term macroeconomic stabilization issues, this study links macroeconomic policies to long-term growth. A major strength of the study is that economic policy changes are analyzed in the context of broader social and political circumstances.

Some aspects of Sri Lanka's development policies have been unique among developing countries and have attracted worldwide attention. In particular, its remarkable achievements in advancing social welfare—achievements comparable

to those of many developed countries—have generated a large literature. However, there has been no comprehensive analysis of Sri Lanka's macroeconomic policies and their implications for welfare and growth. This study fills this gap.

The study offers an overview of the postindependence economic and political developments in Sri Lanka and a new perspective on the interaction between macroeconomic policies, political and social stability, and long-term growth. It challenges widely held views on the relationship between welfare expenditures and growth. The study focuses on the policy experience of two periods (1973–75 and 1978–82), periods when the economy was subjected to major domestic and external stresses. Between these two periods there was a dramatic shift in government policies. A long period of extensive state intervention and inward orientation was followed by a commitment to economic liberalization. The analysis is of broader interest as a study of the reaction of a small open economy to major shocks under sharply contrasting policy regimes and external circumstances.

Publication of this study was made possible in part by a generous grant from SIDA, the Swedish International Development Authority.

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Acronyms

CBC	Central Bank of Ceylon
CBCPI	Central Bank Consumer Price Index
CCI	Construction Cost Price Index
CCPI	Colombo Consumer Price Index
CFL	Ceylon Federation of Labor
CFTU	Ceylon Federation of Trade Unions
CGE	Computable General Equilibrium
CMU	Ceylon Mercantile Union
CP	Communist Party
CRA	Convertible Rupee Account
CWC	Ceylon Workers Congress
DCS	Department of Census and Statistics
DFCC	Development Finance Corporation of Ceylon
DWC	Democratic Workers Congress
EDB	Sri Lanka Export Development Board
EPF	Employee's Provident Fund
FCBUs	Foreign Currency Banking Units
FEECS	Foreign Exchange Entitlement Certificate Scheme
FP	Federal Party
GCEC	Greater Colombo Economic Commission
GDFC	Gross Domestic Fixed Capital
GDP	Gross Domestic Product
GDPD	Gross Domestic Product Deflator
GDPR	Real GDP Growth
GNP	Gross National Product
GOBUs	Government-Owned Business Undertakings
ICC	Insurance Corporation of Ceylon
ICORs	Incremental Capital/Output Ratios
IDRC	Canadian International Development Research Corporation
ILO	International Labour Organization
IMF	International Monetary Fund
IPZ	Investment Promotion Zones
JVP	Janatha Vimukthi Peramuna, or Peoples' Liberation Front
LSSP	Lanka Sama Samaja Party

NSB	National Savings Bank
OGL	Open General License
PMB	Paddy Marketing Board
PSEs	Public Sector Enterprises
PSIP	Public Sector Investment Program
PPP	Purchasing Power Parity
REER	Real Effective Exchange Rate
SDR	Special Drawing Right
SLFP	Sri Lanka Freedom Party
TDR	Trade Dependence Ratio
TULF	Tamil United Liberation Front
UF	United Front
ULF	United Left Front
UNP	United National Party
WPI	Wholesale Price Index

Data Notes

- *Dollars* are current U.S. dollars unless otherwise specified.
- The symbol — in tables means not available.

Chapter One

Introduction

In this book we examine the macroeconomic policies of postindependence Sri Lanka, with emphasis on the period from the mid-1960s to the late 1980s. We focus on domestic and external shocks which subjected the economy to major stresses during this period, and discuss and analyze the specific policy responses and their consequences. These episodes are placed in their historical, economic, and political contexts, and we examine the institutional and ideological influences on policy formation and the responses of economic agents. In contrast to most analyses, which concentrate solely on short-term stabilization aspects, we also attempt to determine the impact of macroeconomic policies on long-term growth.

The overall study period encompasses two shorter periods (1973–75 and 1978–82) during which the economy was subjected to major shocks. Both periods show striking similarities and sharp contrasts in terms of the nature and origin of the shocks, and the policy responses. Although these two subperiods were remarkable for the intensity and magnitude of the shocks, in a sense the entire study period can be considered to have been an era of turmoil. Since the 1970s, Sri Lanka has experienced large fluctuations in its terms of trade, large domestic supply shocks, a dramatic investment boom, and huge capital inflows. Economic policies have ranged from strong state intervention in almost every important factor and product market to a major trade liberalization. Although the economy escaped severe recession, a major inflationary crisis, and a large external debt problem, economic and social developments were often erratic and unpredictable. And as the 1980s ended, Sri Lanka was in the grip of violent political conflict and its economy was in serious trouble. We believe, therefore, that this analysis holds lessons which have broad relevance for many other developing countries.

Sri Lanka's economy shares many structural features with most low-income commodity exporting countries, but there are some important—even unique—differences that distinguish the Sri Lankan macroeconomic policy setting. The evolution of the economy up to the early 1960s was the subject of a widely cited study by Snodgrass (1966), and in the 1970s Sri Lanka was considered to be “one of the

most heavily researched of the developing economies of the world” (Pyatt and Roe 1977:23). In particular, Sri Lanka’s record in achieving standards of literacy, health, and life expectancy comparable to those of many industrial countries despite being one of the world’s poorest countries in terms of per capita income (US\$470 in 1990) has generated a large and notable literature (for example, Isenman 1980; Sen 1981; Bhalla and Glewwe 1986; Anand and Kanbur 1991). Recent studies have also included substantive analysis of trade and industrialization policies (Lal and Rajapatirana 1989; Cuthbertson and Athukorala 1990). However, no studies of Sri Lanka’s macroeconomic policies as such exist, despite their obvious importance to trade, industrialization, and welfare spending. We hope this study will help to fill the gap.

In this study we analyze the policy responses to macroeconomic crises and their consequences, as well as why those, rather than alternative policies, were adopted. This involves an analysis of political economy factors as well as an appreciation of the perceptions and expectations held by policymakers and private agents as they confronted actual or potential crisis situations. The focus of the study, however, is on analysis of the changing economic situation, and no attempt is made to provide political economy explanations.

In chapter 2 an overview of political and economic history since independence is presented. This review of the evolution of the postindependence economy is used to identify the 1973–75 and 1978–82 periods as two critical episodes for detailed analysis. The key structural and institutional features of the economy are described in chapter 3 to provide a background for the analysis to follow.

Our choice of the two periods—which we will refer to as crisis episodes—was guided by the unprecedented stresses to which the economy was subjected at those times, rather than to any catastrophic collapse. As will be described in detail later, the 1973–75 period saw Sri Lanka confronted by a combination of acute domestic supply problems and a dramatic increase in the price of its major imports—oil, rice, wheat, and sugar. Limited trade liberalization in 1968–70, sluggish export performance, and a 22 percent decline in the terms of trade during 1966–70 generated a mini-crisis in 1970 to which the government responded with stringent quantitative controls on imports. Thus, the 1973 shocks hit an economy that was already severely stressed. On the other hand, during the 1978–82 period the economy was stimulated by a massive increase in investment, originating mainly in the public sector. Gross domestic investment rose from 16 to 32 percent of gross domestic product (GDP) within two years, and this investment boom coincided with a drastic 62 percent deterioration in the terms of trade between 1978 and 1982. But in contrast to conditions at the onset of the 1973–75 crisis, external reserves in the late 1970s were very healthy, and a major policy liberalization had opened up the economy. The response of the government to the investment boom involved no significant retreat from a liberal policy orientation, although the pace of liberalization slowed down.

In chapters 4 and 5 the nature of the 1973–75 and 1978–82 macroeconomic crises, the policy responses, and their immediate impact are discussed. Chapter 6

presents a discussion of the consequences of policy responses to these crises for long-term economic growth. The key findings of the study and their implications are summarized in chapter 7.

Chapter Two

Sri Lanka's Political and Policy History

Sri Lanka (commonly called Ceylon until 1972) is a tropical island located south of the Indian subcontinent; at its closest point to the mainland it is less than 50 kilometers from India. It has a land area of 65,610 square kilometers and in 1989 had a population of 16.8 million. Coastal plains and central mountains provide a wide range of environments.

There is little seasonal variation in temperatures. A southwestern monsoon brings rain from April to June, and a northwestern monsoon visits from mid-October to mid-February. On the basis of variations in annual rainfall, the country can be divided into a wet zone, a dry zone, and an intermediate zone. The southwestern region is the wet zone, with annual rainfall averaging 60 to 80 inches in coastal areas and 120 inches in the central hills.

Traditionally, tea, rubber, coconut, and rice (paddy) have been the main agricultural crops. Until recently, the three plantation crops (tea, rubber, and coconut) were the major export earners. In the 1970s exports of gems and garments expanded rapidly, and tourism also became a major source of foreign exchange earnings. The reliance on primary exports has exposed the Sri Lankan economy to severe terms of trade fluctuations and, in the post-World War II period, to a long-term decline in its terms of trade. Recurrent balance of payments problems have plagued the economy in recent decades.

Sri Lanka's recorded history reaches back at least 2,500 years.¹ Sinhalese and Tamil, the languages of the two largest ethnic groups, have a common Indian origin, belonging respectively to the Indo-Aryan and Dravidian linguistic families. According to historical and archeological evidence, today's ethnic identities evolved over time through the intermingling of many waves of migrants from different parts of India, who were absorbed into the dominant linguistic groups. However, myths about the racial origins of these two ethnic groups, which have become entrenched over time, play an important role in Sri Lankan political and social life. The Sinhalese trace their ancestry to a group of North Indian "Aryan" settlers who are believed to have arrived in Sri Lanka around 500 BC, while the

Tamils trace theirs to the ancient Dravidian civilization of South India. The early settlements were located in the dry zone, with rice (paddy) as the main crop. Buddhism became the bedrock of Sinhalese culture and civilization, while Hinduism established itself as the religion of the Tamils.

The north-central plains were the cradle of the ancient Sri Lankan civilization, which was based on a highly sophisticated system of rice irrigation. Thousands of man-made reservoirs dotted the landscape. Many were linked by canals and fed from large central reservoirs that sometimes covered many square miles. Indeed, Sri Lanka became, in time, one of the great irrigation-based civilizations of the ancient world (Farmer 1957).

This civilization, which survived for over a thousand years, succumbed to a combination of factors. Repeated invasions from South India, civil wars, buildup of soil salinity, and the spread of malaria drove the bulk of the population to the wetter, hilly, and more densely forested southwest part of the country in the 13th century. A number of regional kingdoms, including a separate Tamil kingdom in the north, were established during this period.

Western influence on the country began with the arrival of the Portuguese in 1504 and their establishment of rule over the coastal regions. In the historical past, Sri Lanka had traded in spices, gems, and elephants with the Greek and Roman empires in the West and the Chinese empire in the East. At the time of the arrival of the Portuguese, it had a significant trade in spices with Europe. Portuguese rule stimulated the spice trade and initiated a process of modernization of the economy. This process accelerated over the next three centuries as the Portuguese were displaced by the Dutch in the mid-17th century, and the Dutch in turn were replaced by the British at the end of the 18th century. Throughout this period, much of the interior of the country remained independent, the capital having shifted to Kandy.

Given the recent racial conflict in the country, it is worth noting that the royal families of Sri Lanka were closely linked by marriage and family ties to South India, and that the last three "Sinhalese" kings at Kandy were ethnic Tamils. In 1815, Sri Lankan aristocrats, dissatisfied with the king, carried out a coup d'etat and signed a treaty whereby sovereignty was transferred to the British, who in turn promised to protect and maintain traditional customs and rights, including the Buddhist religion. This enabled British rule to be extended over the entire country and ushered in a period of rapid change that soon resulted in the emergence of a classic dualistic export economy (Snodgrass 1966).

Coffee, and then tea and rubber cultivation spread rapidly during the 19th century, and modern plantations were established throughout the wet zone. Popular resistance to the plantation economy, which encroached on subsistence agriculture, erupted into armed rebellion in 1847 and was brutally crushed. The way was then open for the unfettered expansion of the plantations. By the end of the 19th century the economy was dominated by exports of tea, rubber, and coconut products.² The development of the plantation economy was accompanied by the development of an extensive road network. South Indian labor was brought in to provide a resident labor force on the plantations. This, together with the break-up

of the traditional subsistence economy, made the country dependent on imports of its staple, rice. By the time it achieved independence from Britain in 1948, Sri Lanka was a highly trade-dependent country, exporting plantation crops and importing rice, wheat flour, and sugar, as well as manufactured consumer goods.

The Arrival of Independence

Sri Lanka became independent in 1948. Conditions at the time of independence appeared benign. The transfer of power was smooth and peaceful, the population had enjoyed universal suffrage since 1931, and an efficient administrative mechanism was in place. Since 1932, Sri Lanka had been operating under the so-called Donoughmore constitution, which provided a large measure of self-government and provided a framework within which even avowedly revolutionary movements were able to carry out open political activities and participate in the electoral process. Despite considerable wartime stresses, the economy had not suffered any serious dislocations and provided a standard of living in 1948 that was well above that of neighboring countries. In contrast to the violence and turmoil that gripped the Indian subcontinent in the immediate postwar years, Sri Lanka was an “oasis of stability, peace and order” (de Silva 1982). A leading Sri Lankan politician was expressing a widely held view when he stated that, of all postcolonial nations, Sri Lanka would prove “the best bet in Asia” (Jiggins 1976).

But the peacefulness and order of the political and social scene in 1948 were deceptive. They masked deep underlying divisions among social classes and ethnic groups. Politically, society was polarized between the conservative nationalist right and the marxist-oriented left to a degree almost unknown elsewhere in the Indian subcontinent, and there was much industrial strife that erupted into general strikes in 1946 and again in 1947. Ethnic antagonisms were also present, particularly between the Sinhalese nationalists who dreamt of a Sinhalese Sri Lanka and the minority Tamils, who feared that British rule would be replaced by Sinhalese rule. These ethnic tensions had been pushed to the background by political polarization and the anticolonial struggle. All the main political parties were multiracial and included members of minority ethnic groups in their leaderships.

At the general election held in 1947 to elect members to the postindependence parliament, the conservative United National Party (UNP) emerged as the largest party. Yet, despite an electoral gerrymander which gave disproportionate weight to politically conservative rural areas, the UNP was unable to obtain a clear majority, winning less than 40 percent of the vote. But it was able to form a government led by Don Steven Senanayaka, with Solomon Bandaranaike as his deputy, in a coalition with other conservative groups. From the outset, however, the UNP faced a formidable challenge from the left, which was divided between Trotskyists and a smaller pro-Moscow communist party (CP). The Trotskyists themselves were split between the Lanka Sama Samaja Party (LSSP) and the Bolshevik-Leninist

party, a division that lasted for a number of years. Despite this division, the organizational strength and political stature of the left effectively denied the UNP the kind of political dominance enjoyed by similar leaderships elsewhere, such as the Gandhi-Nehru alignment in India.

The peacefulness of the transfer of power from the British to the conservative nationalists deprived the latter of the mass adulation accorded to nationalist leaders in other countries who had won independence through armed battle with colonial rulers. The UNP leaders had been part of the government during the war years and had fully supported the British. The Trotskyists had opposed the war, although the small pro-Moscow communist party had supported it and its members had suffered repression and imprisonment. This gave leaders of the Trotskyite left a high degree of popular support that enabled them to emerge as contenders for power even within the parliamentary framework.

The Political Economy of Consumer Subsidies

The economic problems of the 1930s provided fertile ground for the marxist left to grow rapidly in strength and influence, and leftist agitation over economic hardships compelled the conservative nationalists (later to become the UNP leaders), who were partners in governing, to exert pressure on the British colonial administration to enact measures to alleviate the worst effects of the depression. The implementation of a series of social welfare measures in the 1930s extended to the broader populace measures originally taken to help plantation workers and became the precursor of the extensive welfare system that developed in the postindependence period; this was a conscious response to political circumstances (Corea 1973). Health facilities were greatly expanded, as were educational institutions. An extensive system of food subsidies was adopted during the war years and was intended in part as a way of meeting the leftist challenge (see de Silva 1982). This system of arrangements, which could already lay claim to being a welfare state, was inherited by the new government in 1948. Arguably, violent social conflict had been avoided in Sri Lanka because of the welfare system, and the influence of the left had been contained. Hence, the government in the immediate postwar years had a strong desire to further expand welfare services and thereby deprive the left of popular support. But deteriorating economic conditions in the immediate postindependence period forced the new government to prune the welfare system, although the subsidized rice ration was maintained.

Thus, the possibility of a potentially victorious electoral challenge from the left became a real possibility until the Korean war produced a commodity price boom, led by a surge in the price of rubber. Between late 1949 and early 1951, the prices of Sri Lanka's exports rose almost 40 percent and the country's terms of trade rose by over 30 percent. External reserves improved rapidly, as did the domestic money supply. The government removed certain import and exchange rate

restrictions and the newly established (August 1950) Central Bank began to grapple with the inflationary pressures arising from the export boom.

The boom was temporary, but it had lasting effects through the changes it helped to bring about in government transfers. In October 1950 the government reintroduced a subsidy for consumer purchases of wheat flour and increased the subsidy for rice. The subsidy for rice was increased again in December. These were initially seen as measures to compensate for cost-of-living increases. By late 1950, rice was being marketed at less than half of its landed cost to the government (Karunatilake 1974). In 1950–51, subsidies were estimated to be about a fifth of all government expenditures (Corea 1965). By early 1952, expenditures on rice and flour subsidies exceeded expenditures on development projects (Central Bank of Ceylon 1951). In addition to these food subsidies, there were other transfers, which included the provision of free health care and free education up to the tertiary (university) level.

Export prices declined rapidly in 1951, and in 1952 there was a trade account deficit of 297 million rupees, a sharp departure from the surplus of 238 million rupees the previous year. By the end of 1953 total foreign assets were only about half their 1951 level (Snodgrass 1966). At the same time, import prices were rising. By 1952, imported rice cost more than three times its subsidized price in Sri Lanka's markets. The government's budget deficit then expanded to reflect the increased cost of subsidies.

These welfare expenditures brought about a massive electoral victory in July 1952 for the UNP, now led by Dudley Senanayaka, the son of Don Steven Senanayaka. The government had pledged during the election to maintain consumer subsidies, but in 1953 it found itself facing the choice of reducing food and other subsidies or sharply curtailing other fiscal expenditures. It opted to raise the rice price as well as the prices of publicly provided services, such as transport, postal, and electricity services. Other subsidies, including free meals for schoolchildren, also were cut. The political reaction was explosive.

On August 12, 1953, the country was on the brink of revolution as the Left mobilized a massive public protest known as the *Hartal*, expressed in the form of a general strike. Despite the nonparticipation of the moderate opposition (now led by Solomon Bandaranaike, who had left the UNP), this mass protest shook Sri Lankan society to its roots. Originally conceived as a one-day protest, the *Hartal* erupted into a massive and violent demonstration of opposition to the government. Prime Minister Senanayaka resigned, and the price of rice was immediately reduced and the ration was enlarged. But these actions did not save the UNP from a landslide defeat at the next general election in 1956, and "the political commitment to food subsidies was sealed once and for all" (Snodgrass 1966:194). For the next quarter century, whenever the issue of food subsidies came up, the specter of the *Hartal* haunted every Sri Lankan government.

An Open-Market Economy: 1948–56

During the UNP regime of 1948–56, Sri Lanka maintained an essentially open-market economy. The new government had begun with certain import and foreign exchange restrictions originally imposed by the colonial government in the late 1940s to regulate a rundown of Sri Lanka's external balances in the United Kingdom. In 1950 and 1951 most of these restrictions were removed, aided by an improved balance of payments position due to the price boom. The remaining (and minimal) exchange and import controls were limited to transactions with countries in the nonsterling area, particularly the United States.

At the time of independence in 1948, Sri Lanka had a fixed exchange rate and its currency was fully convertible with the British pound (through its link with the Indian rupee). The Currency Board System of the British colonial government did not permit any independent monetary policy, and deficit financing was impossible. The money supply adjusted automatically to fluctuations in the balance of payments (Corea 1965; Gunasekara 1962). One of the first acts of the new government in 1948 was to obtain advice on the setting-up of a Central Bank from John Exter, an official of the U.S. Federal Reserve System, who had also provided advice on establishing central banks to the Philippines and South Korea. Sri Lankan exchange rate policies continued to be closely tied to those of the United Kingdom, and Sri Lanka devalued the rupee against the dollar following a devaluation of the pound in 1949.

The UNP had laid much stress on agricultural development. From the 1930s, its leaders, particularly Don Steven Senanayaka, were strong proponents of reviving domestic food crop agriculture (based on irrigation schemes) in the now sparsely populated dry zone. This strategy involved large-scale public sector investment in irrigation-cum-land development projects and the resettlement of landless people from the densely populated wet zone, who were primarily Sinhalese (Farmer 1957). It was hoped that the outcome would be the creation of a prosperous and contented farming population.

Direct state intervention to help the development of manufacturing industries was not a policy priority. Indeed, a number of inefficient industries that had been set up during the war years were closed down. The UNP government saw its role mostly as one of encouraging private enterprise. Although it introduced a modest program to revamp some state industries set up during the war years and established some new factories to make Sri Lanka "less dependent on imported manufactured goods" (Amarasinghe 1979:19), the commercial failure of most of the undertakings resulted in a gradual disengagement of the state from commercial and industrial ventures. In 1955 the government passed a law that provided for the conversion of government-owned industrial enterprises into public corporations as the first step in a long-term plan to transfer them to the private sector in the form of joint stock companies. Some state industrial undertakings were converted into public corporations under the law, and some were closed down, before the change in government in 1956 stopped further implementation of the privatization plan.

Two development “plans” were prepared during the early 1950s—a Six-Year Development Plan (1951–57) issued in 1950, and a Six-Year Program of Investment (1954–55 to 1959–60). The former was merely a tied-up version of the budget speeches for 1947–48 and 1948–49, and was prepared only because the launching of the Colombo Plan required the government to submit a development plan to be used as the basis for aid negotiations. It was therefore “purely a pro forma exercise and probably had no influence on policy” (Snodgrass 1966:110). The latter plan was nothing more than a synthesis of the proposals made by a World Bank mission that visited Sri Lanka in 1952 (World Bank 1953). Both of these documents placed heavy emphasis on investment in agriculture and infrastructure with a view to providing the basis for the private sector to play the leading role in the development process. Being merely investment programs of the public sector, they did not include overall growth targets for the economy.

In the area of macroeconomic management, fiscal deficits (financed mainly by borrowing from the Central Bank) became the norm from the early 1950s onwards, except for a brief period between 1954 and 1956. The deficit was the result of the rising cost of providing welfare services, in particular the supply of subsidized food, in the face of nonbuoyant government revenues. Government revenues came mostly from tariffs, and export duties moved upward after 1953. But these export duties were inadequate to bring about a substantial improvement in government revenues. Meanwhile, import duties changed little until the late 1950s. Although imports increased during the decade, the higher revenues from import duties were counterbalanced by larger government expenditures for imports (Snodgrass 1966). No serious attempt was made to develop other revenue sources.

The Shift to Import Controls: 1956–65

The UNP suffered a landslide defeat in 1956 at the hands of a three-party coalition headed by the Sri Lanka Freedom Party (SLFP). The SLFP won the 1956 election by focusing its campaign on a promise to make Sinhala the only official language in Sri Lanka and by making an alliance of convenience with the left. Although the SLFP was not committed in ideological terms to socialism, it was not averse to adopting leftist rhetoric and promising to nationalize all foreign-owned plantations and to take over key industries. These promises did not prevent the coalition from gaining the support of many Sinhalese industrialists and small entrepreneurs who had not prospered under the UNP regime.

The new SLFP-led government soon adopted a ten-year macroeconomic plan that was to cover the 1959–68 period and envisioned an average gross national product (GNP) growth rate of 5.9 percent a year. This growth was to be achieved through a policy of import-substitution industrialization and increased government participation in the manufacturing sector.

A year later, in 1957, the parliament adopted a comprehensive “Scheme of Industrialization” that established a state monopoly over basic and strategic sectors of production. This was accompanied by a State Industrial Corporation Act under which the government would provide the capital needed by new industrial undertakings.

These attempts to restructure the economy, however, came on the heels of an election campaign whose emphasis on the question of language had aroused deep-seated ethnic hostilities, and for that and other reasons the 1956–59 period was a troubled one. The Central Bank sent warnings to the government about increased reliance on foreign borrowers to finance growing budget deficits, yet the deficit continued to grow because of sluggish export volume and adverse shifts in the terms of trade. And on the labor front there were prolonged strikes that were only settled by large increases in wages. These did little to pacify the unions, however, and the left-wing partners in the governing coalition withdrew their support. The SLFP itself was suffering from internal dissension, and this period of unrest culminated in September 1959, when a Buddhist monk assassinated Prime Minister Bandaranaike.

After several months of political turbulence, the UNP was able to regain power in March 1960 through alliances with smaller political parties. The UNP then promptly sought to solidify its position by enlarging rice subsidies for consumers.

That was not enough. In July 1960, in a new election, the SLFP (now led by Bandaranaike’s widow) regained control of the government. A month later, with the trade deficit growing ever larger, the Central Bank imposed selective credit controls to reduce imports of nonessential goods (automobiles, alcohol, cosmetics), and this was quickly followed by the imposition of steeper duties on other imports, including petroleum, tobacco, watches, and textiles.

These anti-import tactics had various purposes. One, of course, was to try to keep the negative trade balance under some sort of control. Another was to protect domestic producers of these items from foreign competition.

Even more drastic measures followed in January 1961—stringent controls on foreign exchange, a complete ban on imports of 49 luxury goods, and licensing requirements for most other imports that amounted in effect to the imposition of quotas.

Along with its trade balance deficit the country also had a large deficit in its domestic budget. The government initially sought to reduce it by proposing reductions in the national rice subsidy program. This proposed move by a nominally sympathetic government outraged the left and the trade unions, whose vociferous opposition prevented the proposed cuts and led to the ouster of the finance minister who had suggested them.

With revenues still far short of expenditures, the government then took another tack to obtain more income; it nationalized foreign-owned oil companies operating in Sri Lanka. This action strained the relationship between Sri Lanka and those countries where the oil companies had their headquarters, particularly the

United States. In retaliation for the nationalization, the U.S. government cut off all financial aid to Sri Lanka under the so-called Hickenlooper amendment.

Nonetheless, the SLFP continued to expand its intervention in the economy, a process it had begun in 1959 with the nationalization of the bus system and a take-over of cargo-handling in the port of Colombo. Between 1959 and 1964 the banking and insurance systems both were taken over by the government. The Bank of Ceylon, the largest domestic commercial bank, was nationalized, and the operations of foreign bank branches were restricted.

These encroachments on the private sector were accompanied by the continued expansion of government control over foreign trade. In 1963 a Foreign Exchange Budget Committee was set up at the Ministry of Finance to allocate foreign exchange on the basis of “national priorities” (Kappagoda 1967), and further foreign exchange controls were imposed in 1964, along with a moratorium on repatriation of profits and dividends, and restrictions on overseas education and foreign travel. By 1965 these extensive exchange and import controls had transformed Sri Lanka’s economy into a highly regulated, protectionist regime. But the economy continued to be highly trade-dependent. Even in 1965, despite the numerous trade restrictions, the combined value of imports and exports was equal to half of GDP.

Why did the government resort to such extensive import-control measures during this period? If the rhetoric of the SLFP is taken at face value, it is possible to find “facts” which would be consistent with an explanation of these actions as resulting from a major ideological shift toward import-substituting industrial policies. But the picture of an ideologically motivated SLFP government embarking on a policy of drastic import restrictions to foster industrialization caricatures the interplay of complex political and economic factors that fashioned government policy during this period. Further, these restrictions were by no means welcomed even by the left. The leading left-wing party, the LSSP, opposed trade restrictions on consumer goods, such as textiles, and attacked the government for protecting the interests of new domestic manufacturing firms at the expense of low income consumers. Pragmatism, rather than any deep ideological commitment, dictated the government’s actions, even though some elements within the government were certainly ideologically inclined to support such policies. The import-substitution rhetoric provided a radical facade that was politically useful.

These actions reflected the political weaknesses of the government. It was not willing, in the end, to run the political risk associated with making drastic expenditure cuts in response to the balance of payments crisis, since that would have involved cuts in consumer subsidies. Thus, the government had little room to maneuver. If consumer subsidies could not be cut and “essential” imports had to be maintained, the government had few options left. Furthermore, the Central Bank, which was hardly a socialist bastion, strongly advocated import controls. While stressing that the most important task was to reduce the budget deficit, the Central Bank also viewed direct action to reduce imports as essential.

Meanwhile, the SLFP regime had to contend with opponents on both the right and the left. The regime survived an attempted right-wing coup d'état by elements within the military in 1961, but faced a major challenge in 1963 when the three main leftist parties formed a United Left Front (ULF) and made demands that included substantial wage increases. In early 1964 the government was forced to back down in a confrontation with a militant left-wing trade union, and a political crisis was precipitated. In July 1964 Mrs. Bandaranaike offered partnership in a coalition government to the LSSP, the leading leftist party, and the other members of the ULF, to head off a trade union challenge.

This offer was accepted by the LSSP and the CP, and was to be a move with profound implications. For the first time since the formation of the leftist movement in the 1930s, the left was no longer in the opposition. As junior partners in the coalition, the left had to take some responsibility for governing while allied to the SLFP, which the left had characterized from its inception as a capitalist party. From 1964 onwards the traditional left renounced its former revolutionary aspirations in practice, if not always in rhetoric. One of the results of this incorporation of the traditional left into the mainstream was the disappearance of a radical leftist opposition.

The coalition government formed in 1964 was short-lived, however, losing a vote of confidence in parliament in November 1964 when some conservative members of the SLFP who opposed the link with the left joined the opposition.

Partial Liberalization: 1965–70

The ensuing election in 1965 did not give any party a majority in the parliament. The UNP, with 39.3 percent of the votes, obtained sixty seats but lacked an absolute majority over the SLFP-led coalition, which obtained fifty-five seats. The UNP then formed a coalition with the Federal Party (FP) (the major Tamil party) and a number of smaller groups to constitute a clear majority.

The generally pro-Western stance of the UNP created a more favorable environment for Western aid to Sri Lanka and also strengthened confidence among foreign commercial banks and lending institutions. The government felt able to rely on greater external financing to overcome its payments problems without further restrictions on imports and entered (for the first time) into a standby agreement with the International Monetary Fund (IMF) to borrow up to US\$30 million. The first US\$15 million was borrowed in July 1965.

A second step was an agreement with the United States on compensation for the nationalization of U.S. oil company holdings. This removed the barriers to a resumption of U.S. assistance, and an aid consortium was set up at a meeting convened by the World Bank. The countries in the consortium included Australia, Canada, Japan, the United Kingdom, and the United States, later joined by the Federal Republic of Germany.

The government also arranged some short-term financing from foreign commercial banks and announced the lifting of the 1964 moratorium on the repatriation of profits, dividends, and other investment income. Funds held prior to the rescinding of the moratorium were remitted in stages, and the government assured potential investors that no such moratorium would apply to new investments. Foreign investors were also advised that they would be protected against expropriation and discriminatory treatment (Fernando 1972).

In addition, some attempts were made to overcome the clear antiexport bias of the economy. A bonus voucher scheme for nontraditional exporters, modelled after a similar scheme in Pakistan (Motha 1971) was introduced in 1966. It granted a bonus of 20 percent in the form of transferable import entitlement certificates to producers of certain nontraditional export items, provided there were net foreign exchange earnings of 25 percent of (FOB) value. The vouchers fetched a handsome premium on the market (Dahanayaka 1977).

The 1967 Devaluation

Except for a partial devaluation against the dollar in 1949 (mainly to provide relief to the British pound) and some change in the rupee/dollar rate in the early 1950s, the exchange rate had remained stable for over fifteen years despite sustained pressure on the balance of payments. But when the British devalued the pound by 14.3 percent in November 1967, Sri Lanka followed by devaluing its rupee by 20 percent against the pound, a net devaluation of 5.7 percent.

The devaluation, however, was followed by government-decreed wage increases for workers in the public sector and in the organized private sector, as well as an increase in taxes on traditional exports. Hence, the devaluation was insufficient to prevent a further buildup of pressure on the balance of payments, and foreign currencies continued to fetch a handsome premium in the black market. The Central Bank (1968) said that while the new rate was a good base rate, it was not enough to permit liberalization of a substantial range of imports. A unitary rate at a further depreciated level might have corrected the situation in some respects, but in other respects it might have created further problems. The 20 percent devaluation was felt to be adequate for major exports but not large enough to solve the problems of other exporters. The devaluation had a similar effect on the import side, producing a sufficient markup in the price of a wide range of essential imports, but failing to bring about a liberalization of all imports. Hence, some system of multiple rates appeared necessary.

In May 1968, after consultations with the IMF, the government introduced a package of trade liberalization measures. The most important element was a Foreign Exchange Entitlement Certificate Scheme (FEECS). Under the scheme, all external transactions were divided into categories A or B. Transactions in category A were to be conducted at the official exchange rate and were to include essential imports, such as rice, flour, sugar, drugs, fertilizer, and petroleum, as well as traditional exports (the three plantation crops). Category B transactions were those

involving nontraditional exports and nonessential imports. These transactions were to take place through a certificate system at a lower (depreciated) rate, and it was expected that this rate (in the form of the prices of Foreign Exchange Entitlement Certificates) would be determined by market forces (as reflected by tender prices offered for certificates issued weekly by the Central Bank).

A substantial range of category B imports (more than a thousand) was placed under Open General License (OGL) rules, and in 1969 (the first year of operation of the scheme) they accounted for 15 percent of the total value of imports. Exporters of category B goods and services were entitled to receive certificates with a face value in rupees equal to the FOB value of exports when the foreign exchange receipts were surrendered to an authorized bank. Those who applied for foreign exchange for payments for imports in this category had to surrender certificates with an equal par value.

A new tariff structure was also introduced as part of the scheme. Most essential items were allowed free entry, while rates ranging from 10 to 300 percent were imposed on other items, depending on degree of nonessentiality.³ These trade liberalization measures were accompanied by a major effort to increase food production, particularly rice production. UNP governments had always sought rice self-sufficiency as a matter of national pride, and failure to achieve that goal had been intensified by the burden of paying for substantial rice imports. With bleak prospects for export products and the newly established import-substituting industries under strain because of shortages of imported inputs, the government envisaged import substitution in agriculture as a way out of its balance of payments crisis (Corea 1973). Policy measures in this sphere included giving high priority to food cultivation under the direct supervision of the prime minister's office, development of agricultural extension services, provision of subsidized inputs (fertilizer, other chemical inputs, credit), and steps to boost the prices received by farmers. The last involved drastically curtailing subsidiary food imports, increasing government-guaranteed prices, and curtailing the subsidized rice ration. These policies culminated in a formal plan to carry out the huge Mahaweli irrigation project.⁴

Despite the government's export promotion rhetoric, the traditional export industries continued to suffer from the anti-export bias embodied in commercial policy (Cuthbertson and Athukorala 1990). Since export duties continued to be a major source of government revenue, the producers of these crops carried a large tax burden. The 1968 policy reforms added to this bias by excluding tea, rubber, and coconut from the FEEC scheme. It was argued that reducing dependence on the three traditional export crops would improve export earnings by stimulating crop diversification. Hence, such nontraditional export crops as cocoa, cinnamon, cardamom, and pepper were included in the scheme to give farmers an incentive to switch away from traditional plantation crops. Policy discussions generally ignored the potential efficiency losses involved in such a strategy. Indeed, given Sri Lanka's comparative advantage in the plantation crops, it is likely that substantial economic losses were incurred through this policy. Further, even for the nontradi-

tional agricultural exports the favorable impact of the FEEC scheme was largely offset by upward adjustments in export duties.

The UNP government continued to favor the expansion of import-substituting industries. Many such industries were located in the public sector and had been started or planned under the previous government. The private sector industries that found conditions most conducive to expansion were those producing consumer goods, particularly the nonessentials kept out by import restrictions.

Government policies between 1965 and 1970 continued to be based on the view that the solution to Sri Lanka's external imbalances, at least in the short run, was to be found through adjustments on the import side. Efforts to increase the country's exports would take time. Gamani Corea, head of the Ministry of Planning and Economic Affairs, expressed it this way (Corea 1971a:31):

Increasing export earnings was particularly difficult since these earnings were not entirely the outcome of Ceylon's own efforts. In the case of tea, for example, an increase in productivity might even aggravate the problem by further dampening world prices. In the case of other items, both traditional and new, earnings could be increased by increased production, but this takes time, calling as it does for new capacity. Such an objective must necessarily loom large in any development program for Sri Lanka, but it does not provide an overnight solution to the payments problem.

Many policy advisers were aware of some of the limitations of an import-substitution strategy (see, for example, Corea 1971b), but the possibility that a policy of promoting import substitution would by its very nature tend to discourage export-oriented industries because of general equilibrium effects was not seriously considered. Moreover, the efficiency losses associated with an import-substitution strategy were generally underestimated or ignored.

Overall, the 1965–70 period can be characterized as one when a weak and hesitant attempt was made to liberalize the economy. The political determination to achieve a full-scale liberalization was lacking, since the government was quite aware that the political opposition could arouse strong anti-government agitation. Moreover, external economic conditions as reflected in the terms of trade continued to be adverse, and low-cost external finance was not forthcoming. In this context the government did not, and probably dared not, contemplate a policy that would redress external imbalance through cutting consumer subsidies and thereby reducing domestic absorption. Attempts to increase output through regulation, production subsidies, and state investment could not go beyond the constraints imposed by large consumer subsidies.

Despite improved economic growth, the relatively successful food production drive, and the ambitious plan for the Mahaweli project, doubts about the government's capacity to achieve sustained economic growth did not cease. The electorate did not forget that a UNP government had once again reduced the total amount of rice available at a subsidized price, even though the new scheme pro-

vided two pounds of rice free to each person per week. Rising inflation, youth unemployment, concern about foreign debt, and the electorate's perception that the government lacked conviction about its own policies produced a landslide victory for the SLFP-led United Front (UF) in the 1970 election. The UNP's hesitant attempt at liberalization was over.

After the election, UNP leader Dudley Senanayaka commented that by tampering with the rice subsidy for the second time in his political career he had paid the penalty for "disturbing the most cherished of Sri Lanka's sacred cows" (de Silva 1981). This probably understated the importance of many other sources of popular dissatisfaction with the government, but there was more than a grain of truth in it.

Regulation and Controls: 1970–77

The new United Front government came into office at a time when economic circumstances were worsening but popular expectations were high. The UF had attacked Senanayaka's UNP for reducing the rice subsidy and had pledged to restore it, and the inclusion of the LSSP and CP in the coalition added credibility to this promise. Many expected the new government to usher in an era of prosperity that would eliminate poverty, landlessness, and unemployment.

The rhetoric and some of the actions of the new government during its first few months in power might have suggested that the UF coalition was set on a "socialist march," but the reality was more complex. The formation of the Front had not eliminated key differences between the three parties that formed the alliance. While the SLFP was willing to impose state controls and regulations, it was not, despite its occasional populist posturing, a party committed to overthrowing the existing order. The coalition with the LSSP and the CP was the product of special circumstances (Wilson 1979).

Under Mrs. Bandaranaike the SLFP retained its dominance within the coalition when fundamental issues were at stake, even though some of the long-held views of the leftist parties influenced the course of economic policy in this period. In general, the LSSP and CP gave higher priority than the SLFP to equity issues, had a stronger commitment to the public sector, and did not want to be "dictated to by the IMF and the World Bank." Consequently, the two parties were reluctant to engage in large-scale foreign borrowing that involved conditionality. They also had much greater faith than Mrs. Bandaranaike in the efficacy of government controls.

In April 1971, less than a year after coming to power, the UF government was faced with an armed insurrection led by the Janatha Vimukthi Peramuna (JVP, or Peoples' Liberation Front), an organization composed mostly of educated but unemployed rural Sinhalese youths. The JVP was the largest of several radical organizations devoted to rectifying what was seen as a betrayal of socialism by the traditional leftist parties. The JVP's best-known leader, Rohana Wijeweera, had

briefly been a member of a Maoist group that had split from Sri Lanka's pro-Moscow communist party in 1963.

The JVP combined populist rhetoric with Sinhalese nationalism. It was a measure of the high expectations that greeted the election of the UF government, and the rapidity with which disillusionment subsequently set in, that the JVP was able to attract thousands of youths to launch an armed challenge to the new government so soon after the election. But the JVP lacked wider support in the community, and its uprising was crushed by the government with the help of military and political support from both the Western and Communist blocs. Estimates of the dead ran to thousands.

Abortive though it was, the JVP's uprising sent shock waves through Sri Lankan society and had far-reaching consequences. The government sought to assuage its supporters on the Left while taking other steps to entrench its rule. These included a significant degree of land reform in 1972 and a takeover (with compensation) of foreign-owned tea and rubber plantations in 1975 (Fernando 1978 and 1980; Peiris 1977). Foreign policy also shifted. Even though the USSR and China had rushed in with support (including military equipment) during the uprising, Mrs. Bandaranaike chose to strengthen Sri Lanka's ties with the west. Defense expenditures began to rise, and the government moved toward more authoritarian forms of rule. This was facilitated by changes in the constitution that circumscribed the power of the judiciary to restrain the activities of the government. When the UNP launched a civil disobedience campaign in 1974 to demand elections in 1975, its public meetings and other activities were banned.

Meanwhile, Sri Lanka was suffering from a combination of external and internal shocks. These included the first oil price shock, large increases in the prices of the main food imports, and shortfalls in outputs of the major agricultural crops. The measures taken to deal with this crisis imposed economic hardships not experienced by the Sri Lankan population since the 1940s.

One of the UF's objectives was the "laying of the foundation for the building up of a socialist society" (Budget Speech 1970:3). This meant the further extension of state control over the economy. As soon as it came into power, the new government created an individual licensing scheme for all imports—in other words, a system of quantitative restrictions. The FEECS was retained, but exchange controls became more stringent. These measures were aimed at averting an immediate balance of payments crisis, given a rapid increase in the import bill and a rapid fall in external reserves during the last year of the previous government.

Seven new industrial corporations were established by the government during the period 1970–77. A Paddy Marketing Board was established in 1971 and became the sole buyer of paddy from farmers. Most of the plantation sector also came under state ownership. Under the Land Reform Act of 1972 (and amended in 1975), 63 percent of the total area under tea, 32 percent of the area under rubber, and 10 percent of the area under coconut were nationalized. Earlier, in April 1971, the parliament had passed a Business Undertakings Acquisition Act that empowered the Minister of Finance to acquire any business firm if the acquisition was

considered to be in the national interest. By 1977, 26 business ventures had been converted into Government-Owned Business Undertakings (GOBUs).

The focus of economic policy continued to be import substitution (Sri Lanka Ministry of Planning and Employment 1972), but some steps were taken to stimulate exports because of balance of payments pressure. The FEECS premium was raised to 65 percent and a convertible rupee account (CRA) was introduced to give further incentives to exporters. Permission to establish such accounts, limited originally to gem exporters, was later extended to other nontraditional exporters. It allowed a portion of export earnings to be used to finance imports and to pay for foreign travel, education, and other activities that had to be paid for with foreign exchange.

Although a white paper on direct foreign investment was issued in 1972 to encourage foreign investment, the climate for such investment (indeed, for private investment in general) was not congenial. Ceilings on incomes, land reform, limits on ownership of dwellings, and the 1971 acquisition law all created a climate of uncertainty (Athukorala 1984).

Moreover, the Exchange Control Act of 1971 made it compulsory for residents of Sri Lanka to declare any asset owned abroad within one month of acquisition. The act also prohibited residents from having overseas bank accounts and from disposing of foreign funds without the permission of the Exchange Controller. Under another provision of the act, proceeds from the liquidation of companies by nonresidents were placed in blocked accounts, the balances of which could be remitted abroad only under special circumstances. In the case of profits earned by nonresident shareholders, remittances were allowed only up to 12.5 percent of invested capital.

The most unexpected changes were those involving welfare expenditures. The subsidized rice ration was increased to "two measures" (that is, four pounds) per person. But the terms of trade fell by 23 percent from 1970 to 1972 as import prices doubled, and because of the expansion of the rice subsidy and a drastic decline in domestic production because of bad weather, rice imports were 40 percent higher in 1971 than in 1969. Despite increased aid from the centrally planned economies, Sri Lanka found it impossible to finance its already very low level of imports. By the time of its second budget in November, 1971, the government had taken steps to reduce food subsidies and other welfare expenditures. A series of price hikes followed. The price charged to consumers for the rice ration was raised by 25 cents to 1 rupee. Sugar, which had been available at 72 cents per pound in unlimited quantities, was brought under rationing. Only three pounds per month were available at 72 cents a pound, while quantities above this were priced at 1.50 rupees per pound. In March 1972, the sugar ration was further reduced to two pounds per month, and the price was raised to 2.50 rupees per pound. In November 1972 wheat flour was rationed (one pound per week). Income tax payers were declared ineligible for subsidized free rice in December 1972. The price of wheat flour was increased from 33 cents per pound to 38 cents per pound in January

1973, and again, to 48 cents in June 1973. In November 1973 the rice ration was reduced to one pound per week.

These reductions in food subsidies were accompanied by other reductions in government outlays. Bus and rail fares, as well as postal, telephone, and telegraph charges, were increased. Not since 1953 had any government reduced welfare expenditures on such a scale, though the remaining subsidies were still very substantial.

The political problems within the UNP in the immediate aftermath of the election and the crushing of the JVP left no viable political opposition to the regime. The bulk of the trade union movement was under the control of the LSSP and the CP, and the trade union leaders had become partners and defenders of the regime. Moreover, certain measures could be justified to the electorate as the cost of dealing with the insurgency.

By 1975, however, mass opposition to economic hardship could no longer be contained. Tensions within the government severely weakened the influence of the LSSP, and in 1975 the party was compelled to leave the coalition. Soon after, the killing of a university student by the police led to an upsurge of protests against the government, and the CP, which had remained in the coalition after the LSSP's departure, bowed out just before the 1977 general election. The electorate then delivered a massive defeat to all the parties that had been associated with the United Front. During the campaign the UNP had urged liberalization of the economy, arguing that the lifting of trade restrictions would end the shortages of consumer goods and lead to rapid economic growth and full employment. This message had a great appeal to an electorate that had suffered from several years of economic hardship and authoritarian politics.

The Turnaround in Economic Policy after 1977

The 1977 election was the first in which a majority of the votes was cast for a single party. The UNP, led by J. R. Jayawardene, won 140 out of a total of 168 seats, while the SLFP slumped from 90 to a mere 8. Not a single candidate from the Left was elected. Even allowing for the "first past the post" election system, this change suggested that political allegiances had become more volatile.

The triumph of the UNP was welcomed by the Western powers, since Jayawardene had always shown a pro-Western orientation. When the new government began an extensive reform of exchange rate and trade policies after taking office, the Western powers and the international agencies (which had long pressured for such reforms) responded with an unprecedented flow of aid (Levy 1985).

The elections also marked a new phase in the Tamil community's growing separatist movement. The Tamil United Liberation Front (TULF) won a sweeping victory in the traditional Tamil areas of the North and Northeast with its pledge to strive for an independent Tamil state. TULF, with eighteen members in the parliament, became the largest opposition party.

During its seven years in opposition, the UNP had seen how the UF coalition had prolonged its tenure, and the new government lost no time in capitalizing on its two-thirds majority to change the constitution in ways favorable to itself. Under the new rules, future parliaments would be elected on a proportional basis (almost guaranteeing that no party would have the power to reverse the UNP's changes in the constitution) and the new document also provided for simplified decisionmaking through a centralization of executive power in the office of the president. Jayawardene was, of course, the overwhelming choice for the job (Wilson 1980).

The new administration initiated significant economic policy reforms soon after entering office.⁵ Quantitative restrictions on import trade were largely replaced by tariffs under an open general licensing system. These tariffs usually provided lower levels of nominal protection for domestic import-substitution industries. A number of measures to encourage direct foreign investment, including general tax incentives and the establishment of an export processing zone, were implemented. Most price controls were removed. Universal food subsidies were replaced by a food stamp scheme whose beneficiaries were to be those who earned the least income. As it turned out, however, the scheme actually covered more than half of the population.

The exchange rate system was also reformed. The exchange rate was unified by eliminating the FEEC and CRA schemes, the rupee was devalued by 45.5 percent (from 9.1 rupees per U.S. dollar to 16.7 rupees per dollar), and a managed float was adopted with a view to making the exchange rate an active policy instrument.

The lifting of many restrictions on capital transactions was an important step toward greater integration of the domestic capital market with the international market. However, the rupee was not made fully convertible. Repatriation of proceeds from sales of shares in Sri Lankan companies was permitted without prior approval of the Controller of Exchange, and foreign exchange dealers were permitted to approve applications for such remittances. Moreover, foreign investors were allowed to repatriate their capital contribution to the equity of a company upon sale or liquidation of the investment. Transfer of shares was freely permitted if it did not increase the ratio of nonresident shareholdings originally approved. Stringent restrictions on the release of foreign exchange for foreign travel and study abroad were relaxed. As in the past, however, residents of Sri Lanka were not permitted to invest abroad, to maintain accounts with banks abroad, or to raise capital in foreign markets for domestic investment without prior approval.

Financial repression was eased. Measures aimed at permitting interest rates to attain realistic levels were introduced in 1977 (Hettiarachchi 1978). Then, in 1979, the Finance Act (promulgated in 1961) was amended to allow foreign banks to once again set up branches in Sri Lanka. This was accompanied by a foreign currency banking scheme under which commercial banks would be authorized by the Central Bank to operate foreign currency banking units.

Export expansion was also accorded high priority. The main elements of the reform, such as trade liberalization, relaxation of controls on foreign exchange transactions, a more realistic value for the rupee, and the elimination of various

controls on private sector activities, were intended to generate an economic climate conducive to export expansion. However, it was recognized that these policies alone could not be expected to generate the desired export push in a country whose traditional exports were a small number of primary products and which retained a strong import-substitution bias (Santiapillai 1981). To provide additional direct support for exports, a Sri Lanka Export Development Board (EDB) was established in 1979.

Unlike its predecessor, the EDB was a semi-governmental body with independent legal and financial status. Its activities were financed by an Export Development Fund made up of direct contributions from the Treasury and receipts from a 10 percent cess on imports subject to duties of more than 50 percent and a 2 to 10 percent cess on certain minor agricultural exports. The EDB set in motion a wide range of export promotion schemes, including a revised duty rebate scheme, direct cash subsidies to exporters of designated products, medium- and long-term credit schemes to finance export-oriented investment, annual presidential export awards, and a number of schemes aimed at enlarging the volume of nontraditional exports. In addition, a preshipment refinance scheme operated by the Central Bank for non-traditional exporters got underway in the second half of 1978.

Another important aspect of export policy was the establishment of a Greater Colombo Economic Commission (GCEC) to organize and operate export processing zones (investment promotion zones or IPZ) that would attract direct foreign investment. The first investment promotion zone, at Katunayake near the Colombo International Airport, was opened in June 1978. The incentives offered to IPZ investors included allowing 100 percent foreign ownership in investment projects, a tax holiday for up to ten years on the salaries of foreign personnel, royalties, and dividends, and a duty exemption for imported machinery and other production inputs (Ramanayake 1984).

The liberalization of 1977–78 was accompanied by a massive public sector investment program whose chief components were the Accelerated Mahaweli Development Project and a housing construction program sponsored by Prime Minister R. A. Premadasa. Initially, the Mahaweli project was intended to be spread over thirty years, but the new government decided that it was necessary to complete most of the project within five or six years.

The housing program included a Public Sector Housing Program with a construction goal of 100,000 urban dwellings and a Rural Housing Program with a goal of one million dwellings. Other government projects given priority included construction of a new administrative capital (Sri Jayawardenepura) and a new parliament house. The huge fiscal stimulus and the policy reforms—which were accompanied by large capital inflows from aid donors, remittances sent by a growing number of migrant workers in the Middle East, and larger tourist revenues—brought about rapid growth.

Not everything was favorable, however. The tea price boom of 1976–77 collapsed in 1978, and from 1979 onward the effects of the second oil shock began to be felt in a steady downward movement in the terms of trade. The economy had

begun to show signs of major macroeconomic strain in 1980, when rapid growth in the money supply led to strong inflationary pressures. In July 1980 these pressures led to a major strike by government employees. The government then used its emergency powers to dismiss thousands of government workers. Meanwhile, as the terms of trade decline started to affect the current account, official aid proved insufficient to finance necessary imports. Loans from commercial sources had to be obtained to meet payment obligations.

The 1978–82 period was unique in many ways. The unprecedented capital inflows, huge surge in investment, and sharp fluctuations in terms of trade created enormous adjustment pressures. All the ingredients for a crisis were there, but no crisis occurred. Nonetheless, we call this the second crisis episode and analyze it in more detail below.

External pressure had eased by 1984, but the country was then confronted by a major domestic crisis. The 1971 JVP uprising had signalled that the long period of peace and stability in Sri Lanka might be ending, and simmering ethnic tensions eventually escalated into large-scale violence in 1983, opening a new chapter in Sri Lanka's history.

The Rise of Ethnic Hostility

A series of incidents that culminated in police action in 1979 against Tamils in Jaffna led to the burning down of a library housing Tamil literary manuscripts. After widespread anti-Tamil rioting in 1979 in predominantly Sinhalese areas (including the capital, Colombo), large numbers of Tamils began moving northward.

These events also resulted in a major change in Tamil political leadership. Militant armed groups emerged as the new leaders, replacing an older generation of moderates. Years of frustration with the policies of successive Sinhalese governments had led these Tamil militants to the conclusion that the only acceptable alternative was the establishment of a separate Tamil state that would be called Ealam.

The ethnic conflict then took a dramatic turn for the worse in 1983, when a group of Tamil political prisoners being held in jail in Colombo was massacred and no action was taken by the authorities to punish those responsible. This precipitated widespread armed conflict in the Tamil dominated northern and eastern provinces, and a full-scale civil war got under way.

Large numbers of Tamil refugees fled across the water to Tamil Nadu, an ethnic Tamil state in South India that was also used by various militants as a base for conducting the armed conflict in Sri Lanka. Meanwhile, Sri Lanka's predominantly Sinhalese armed forces moved into the northern and eastern provinces, and in the ensuing battles Tamil civilians suffered heavy casualties. These events strained relations between Sri Lanka and India, but the two governments agreed to allow Indian armed forces to occupy the northern and eastern provinces in 1988.

The goals of both countries were to disarm the Tamil militants and prepare the ground for a settlement within the context of a unified state. The Indian army was unable to disarm the main Tamil group, however, and eventually withdrew in 1990.⁶

In the meantime a rejuvenated JVP found itself able to exploit the grievances of segments of the Sinhalese population and the widespread anti-Indian feelings of Sri Lanka's Sinhalese majority. The JVP launched a campaign of terror in Sri Lanka's southern Sinhalese-dominated areas that was only halted after two years of savage conflict.

Economic growth slowed to a crawl, and exports stagnated. Unemployment, which had declined in the early post-1977 period, started to increase, and by the end of the 1980s was estimated to be around 15 percent. There were continuing pressures on the balance of payments, and a major crisis was averted only because of substantial assistance from Japan and Western donors. In the midst of a deteriorating situation J. R. Jayawardene resigned as president in early 1989 and was replaced by Premadasa. A program to alleviate poverty was launched, and after remaining unchanged for a decade the nominal value of food stamps was increased. Although economic policy continued to be dictated by military imperatives as the decade ended, moves to implement a series of large-scale privatization initiatives were put back on the political agenda.

As Sri Lanka entered its fifth decade of independence, the "best bet of Asia" in 1948 was being tragically transformed. By 1990 Sri Lanka was a simmering volcano of political, social, and ethnic conflicts despite the restoration of a semblance of political stability and a degree of recovery in economic performance. Even this hesitant recovery was threatened by the Iraqi invasion of Kuwait, which dealt new blows to the battered economy by disrupting a major market for exports of Sri Lankan tea and by eliminating large numbers of jobs in the Middle East for migrant workers from Sri Lanka.

Chapter Three

A Profile of the Economy

Sri Lanka's major ethnic group is the Sinhalese, who at the time of the 1981 census accounted for 74 percent of the population (Table 3.1). Sri Lankan Tamils, Indian Tamils (descendants of immigrant workers from South India in the late 19th and early 20th centuries), and Moors (descendants of the Arab traders who settled in Sri Lanka centuries ago) accounted for 12.6 percent, 5.6 percent, and 7.4 percent, respectively. Over the past forty years the Sinhalese and Sri Lankan Tamil proportions have increased slightly while the proportion of Indian Tamils has declined, mainly because of a ban on further immigration in 1957 and the repatriation of Tamil laborers under a 1964 agreement between the governments of Sri Lanka and India.

Most of Sri Lanka's Sinhalese are Buddhists, most of its Tamils are Hindus, and most of its Moors follow Islam. Christians, particularly Roman Catholics, constitute an important religious minority.

The population of Sri Lanka increased from 6.7 million in 1946 to 16.8 million in 1988 (table 3.2). This rapid increase reflected a spectacular decline in the

Table 3.1 Ethnic Composition of the Population, Selected Years, 1946–81
(percentage of total population)

<i>Ethnicity</i>	<i>1946</i>	<i>1953</i>	<i>1963</i>	<i>1971</i>	<i>1981</i>
Sinhalese	69.4	69.4	71.6	72.0	74.0
Tamil	22.7	23.0	21.6	20.5	18.2
Ceylon Tamils	11.0	11.0	11.0	11.2	12.6
Indian Tamils	11.7	12.0	10.6	9.3	5.6
Muslims	7.1	6.3	6.4	6.7	7.1
Others ^a	5.8	1.3	0.4	0.8	0.7

a. Burghers and Eurasians, Malays, Europeans, and Veddhas.

Source: Government of Sri Lanka, Department of Census and Statistics, *Statistical Abstract* (annual).

death rate (particularly in the 1940s and the 1950s) and occurred despite a moderate decline in the birth rate. The crude death rate declined from twenty-three per thousand in 1946 to seventeen per thousand in 1953, and then to six per thousand in the 1980s. The birth rate showed little change up to about the mid-1960s but then trended downward, reflecting the success of a national family planning pro-

Table 3.2 Population and Vital Statistics, 1946, 1953, and 1963–88

<i>Year</i>	<i>Population mid-year (millions)</i>	<i>Birth rate (per 1,000)</i>	<i>Death rate (per 1,000)</i>	<i>Net migration rate (per 1,000)</i>	<i>Population growth rate (percent)</i>
1946	6,657	19.9	23.1	+1.6	2.55
1953	8,099	31.0	16.8	-0.3	3.62
1963	10,651	34.1	8.6	-1.0	2.55
1964	10,889	33.2	8.8	-1.0	2.44
1965	11,133	33.2	8.2	-0.5	2.50
1966	11,439	32.3	8.3	-0.5	2.40
1967	11,703	31.6	7.5	-0.6	2.41
1968	11,992	32.0	7.9	-0.7	2.41
1969	12,252	30.4	8.1	-0.9	2.23
1970	12,516	29.4	7.5	-0.8	2.19
1971	12,608	30.4	7.7	-2.7	2.27
1972	12,861	30.0	8.1	-3.2	2.19
1973	13,091	28.0	7.7	-3.8	2.03
1974	13,284	27.5	9.0	-4.0	1.85
1975	13,496	27.8	8.5	-2.3	1.93
1976	13,717	27.8	7.8	-3.8	2.00
1977	13,942	27.9	7.4	-3.7	2.05
1978	14,190	28.5	6.6	-2.8	2.19
1979	14,472	28.9	6.5	-3.0	2.24
1980	14,747	28.4	6.2	-4.6	2.22
1981	15,011	28.2	5.9	-3.3	2.23
1982	15,189	26.8	6.1	-6.0	2.07
1983	15,416	26.2	6.1	-6.8	2.01
1984	15,599	24.8	6.5	-4.9	1.83
1985	15,837	24.3	6.2	-0.6	1.81
1986	16,117	22.3	5.9	-2.7	1.60
1987	16,586	20.7	5.8	-3.1	1.49
1988	16,806	21.3	6.2	-1.2	1.51

Source: Government of Sri Lanka, Department of Census and Statistics, *Statistical Abstract* (annual); and Central Bank of Ceylon, *Sri Lanka: Socio-Economic Data* (1991).

gram and a continuing rise in the average age of marriage. The rate of overall annual population growth, which had been around 2.5 percent up to the mid-1960s, had declined to about 1.5 percent by 1988.

One consequence of rapid population growth in the immediate postwar period was a population structure with a large proportion in the younger age categories. In 1981, 46 percent of the population was under 20. As a result of improvements in basic health care, average life expectancy had risen to 70 by 1988.

With the exception of the return of plantation workers to India, Sri Lanka did not experience significant outmigration until fairly recently. The first wave of outmigration occurred when considerable numbers of the Burgher community left the country to settle in Australia, Canada, and the United Kingdom, particularly after the change in the official language after 1956. The early 1970s saw the beginning of the emigration of professionally qualified personnel from all communities for foreign employment, an outflow which accelerated as new employment opportunities developed in the Middle East. Such opportunities also emerged for relatively unskilled labor. Between 1976 and 1984, approximately 318,000 Sri Lankan workers emigrated, mainly to the Middle East, for temporary employment. The estimated stock of workers abroad increased from 740 in 1976 to 38,100 in 1980 and 129,609 in 1984 (Athukorala 1990).

Nearly 80 percent of the country's population lives in rural areas, and there has been no significant trend toward urbanization. Colombo is the only large urban center; a few smaller cities have developed as regional administrative and commercial centers. It should, however, be noted that describing the population as "rural" is somewhat misleading. Thanks to a well-developed and cheap transport system, large numbers of workers commute to paid employment in urban centers while living in rural areas. About two-thirds of the population lives in the wet zone, which comprises about a third of the land area. The Sri Lankan Tamils have traditionally lived in the northern and eastern parts of the country, though significant numbers are settled elsewhere, including Colombo. Most of the Indian Tamils live in the wet zone regions where the tea and rubber plantations are situated.

Land and Resources

Sri Lanka is a densely populated and largely agricultural country. It does not possess any major mineral resources, with the exception of semi-precious gems and graphite.⁷ About 60 percent of the land area of 64,454 square kilometers is cultivable, and about 35 percent is under cultivation. Paddy (rice), the main staple crop, accounts for about 45 percent of the land under cultivation, while tea, rubber, and coconut occupy about 42 percent. These proportions have changed somewhat in the past four decades, the main change being a doubling in the size of the rice area. Widespread adoption of modern high-yielding varieties and chemical inputs, as well as the bringing of new land under cultivation, has raised rice production

considerably, and Sri Lanka is now close to self-sufficiency in rice. The cultivation of rice, as well as of most other food crops, is primarily a smallholder activity; a majority of the farms are less than two hectares in size. (After land reform was carried out in the 1970s, large private holdings ceased to exist.)

The overall population density is close to 250 per square kilometer, while agricultural population density exceeds 700 per square kilometer. Fast-flowing rivers originating in the central hills provide some hydroelectric power, but Sri Lanka imports oil to meet most of its energy requirements (about 71 percent in 1989).

Growth and Welfare

Between 1950 and 1989, Sri Lanka's real GDP increased at an annual compound rate of 3.07 percent in absolute terms and 1.05 percent in per capita terms. This growth was far from smooth. If the 1968–70 period (during which Sri Lanka experimented with trade liberalization reform) and the five years following the 1977 policy reforms are excluded, these rates fall to 2.5 and 0.7, respectively. A marked decline in growth after about 1983 reflected the damaging impact of ethnic conflicts. As a result of the decline in the population growth rate, the annual growth rates of absolute and per capita GDP have moved closer to each other since the late 1970s.

The World Bank now classifies Sri Lanka as a low-income country. In 1988, per capita annual income was US\$375 (World Bank 1989). At the time of independence (and until about the 1960s), however, per capita income was comparable to, and often higher than, that of several Southeast Asian countries even when measured in conventional terms. According to purchasing power parity (PPP) adjusted GDP estimates of Kravis, Heston, and Summers (1982) (table 3.3), Sri Lanka's per capita income in 1950 was almost twice that of India, higher than those of Thailand and South Korea (henceforth Korea), and only marginally lower than that of Malaysia. Even in 1960, Sri Lanka's income level was similar to that of Korea as conventionally measured; by PPP adjusted measures, it was similar to that of Colombia, and well above those of Brazil and Korea. Since then it has slipped below these, and many other countries, by both yardsticks.

Even now, however, Sri Lanka performs quite well in terms of most social indicators. In 1988 its adult literacy rate was 85 percent, almost all children of primary school age were enrolled in schools, and 56 percent of the eligible age group was enrolled in secondary schools. Infant mortality was 37 per thousand, well below the average of 56 for upper-middle income countries. Because of these achievements, Sri Lanka has often been cited as an example of a country that has been able to provide its people with a high standard of living despite relatively slow growth and low GDP (Sen 1981).

It has also been argued, however, that the picture is much less impressive when one shifts from a single-period cross-country comparison to a time series

Table 3.3 Per Capita GDP of Selected Asian Countries as a Percentage of the Per Capita GDP of the United States*(purchasing power adjusted)*

<i>Country</i>	<i>1950</i>	<i>1960</i>	<i>1970</i>	<i>1979</i>
India	7.1	7.5	6.5	5.7
Korea	7.6	8.2	11.8	24.8
Malaysia	14.6	16.7	15.6	23.2
Pakistan	9.0	7.8	8.4	7.6
Philippines	10.3	11.4	11.7	13.3
Sri Lanka	11.4	10.2	9.4	9.4
Thailand	9.9	9.5	11.7	13.4

Source: Kravis, Heston, and Summers (1982), table 1.4.

analysis that takes into account Sri Lanka's initial relative position and its capacity to improve upon (or at least to maintain) that position (Myint 1985; Bhalla and Glewwe 1986). In the first two decades after independence, Sri Lanka's standard of living, measured by the usual indicators, remained well above those of other developing countries. Since then, however, Sri Lanka has slipped. In 1950, for instance, Sri Lanka's school enrolment rate (54 percent) was higher than that of Korea (43 percent) and comparable to that of the Philippines (59 percent). By 1979, however, both Korea (at 94 percent) and the Philippines (at 85 percent) had surpassed Sri Lanka (at 74 percent) in terms of this measure. In 1950, Sri Lanka's infant mortality rate (number of deaths per 1,000 live births) was 77, compared with 102 for the Philippines, 84 for Thailand, 85 for Korea, and 91 for Malaysia. By 1985, Sri Lanka, with a rate of 36, ranked behind Malaysia (28) and Korea (27), and both Thailand (43) and the Philippines had improved more rapidly than Sri Lanka. Nevertheless, the overall performance of Sri Lanka in terms of social welfare indicators has been quite outstanding. Anand and Kanbur (1991), in a detailed analysis of the Sri Lankan experience, have demonstrated that these achievements can be attributed to government expenditures on food, health, and education.

The Structure of the Economy

At the time of independence, Sri Lanka was a prime example of an economy heavily dependent on a limited range of agricultural export commodities. In 1948, the earliest year for which economywide national account data are available, the direct contribution of the three plantation crops (including processing) to GDP was 32 percent. In addition to this direct contribution, a host of activities in the services

sector embracing trade, transport, and finance depended on the plantation economy. Local produce accounted for only 25 percent of domestic absorption of goods, and export earnings from the three plantation crops covered over 95 percent of the import bill (Dasgupta 1949).

Data on sectoral growth and the changing composition of GDP between 1950 and 1989 are summarized in tables 3.4 and 3.5. The production pattern exhibited only limited structural changes during the immediate postindependence period up to the early 1960s; the pattern then began a profound shift. The GDP share of the primary sector (agriculture, forestry, and fishing) declined from 46 percent in 1960–64 to 37 percent in 1970–77 and 27 percent in 1984–89. By the late 1980s, the share of plantation agriculture was only one-third of the average share in the 1950s, while the share of domestic agriculture had come to exceed that of export agriculture. The share of the industrial sector, which was steady at around 10 percent up to about the mid-1950s, expanded rapidly thereafter, surpassing 20 percent by the late 1980s. This was mostly a reflection of rapid growth in the manufacturing sector, the share of which increased from 5 percent in 1960–64 to 13 percent in 1984–89. During the 1960s and until the mid-1970s, the sector expanded in response to the impetus given by import restrictions and public sector investment. Since the late 1970s the most dynamic sector within manufacturing has been the garment industry, which has emerged as a major earner of foreign exchange. The share of the services sector increased steadily until the mid-1970s and then expanded very rapidly following the 1977 policy reforms. In general, the data show

Table 3.4 Gross Domestic Product of Sri Lanka, 1950–89, Sectoral Composition at Constant Factor Costs

(average GDP share)

<i>Sector</i>	<i>1950–54</i>	<i>1955–59</i>	<i>1960–64</i>	<i>1965–69</i>	<i>1970–77</i>	<i>1978–83</i>	<i>1984–89</i>
Agriculture, forestry, fishing and hunting	46.6	45.5	46.1	41.4	36.8	24.8	27.2
Export agriculture	29.8	27.7	26.7	22.7	17.0	10.2	8.7
Domestic agriculture	14.1	14.6	8.3	15.6	17.5	11.8	14.9
Industry	11.2	11.0	10.3	12.9	16.5	19.0	21.4
Construction	4.2	4.9	2.4	4.7	4.9	4.8	7.3
Manufacturing (excluding export processing)	5.0	5.1	5.6	7.5	9.1	9.7	12.9
Services	42.3	43.8	43.6	45.6	46.7	56.2	51.4
Total GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: Estimates for 1950–70 are at 1959 factor cost; estimates for 1971–83 and 1984–89 are at 1970 and 1982 factor cost.

Source: For 1950–78, Savundranayagam (1983); for the rest of the period, Central Bank of Ceylon, *Annual Report* (annual).

Table 3.5 Gross Domestic Product of Sri Lanka, 1950–89, Growth Rates at Constant Factor Costs*(average growth rate)*

<i>Sector</i>	<i>1950–54</i>	<i>1955–59</i>	<i>1960–64</i>	<i>1965–69</i>	<i>1970–77</i>	<i>1978–83</i>	<i>1984–89</i>
Agriculture, forestry, fishing and hunting	3.9	2.5	2.5	2.4	2.1	4.1	1.1
Export agriculture (including export processing)	2.9	1.4	1.5	0.5	-1.7	0.5	1.7
Domestic agriculture	10.2	4.2	7.0	5.6	3.5	5.3	0.6
Industry	3.4	1.7	7.6	12.0	1.0	4.2	3.9
Construction	11.8	2.4	5.0	13.1	-2.6	8.8	1.0
Manufacturing (excluding export processing)	-1.4	1.6	10.1	11.6	2.3	6.4	5.7
Services	6.5	2.5	3.7	3.8	3.7	7.2	2.9
Total GDP	4.5	2.5	4.1	4.8	2.9	6.0	2.6

Note: Estimates for 1950–70 are at 1959 factor cost; estimates for 1971–83 and 1984–89 are at 1970 and 1982 factor cost.

Source: For 1950–78, Savundranayagam (1983); for the rest of the period, Central Bank of Ceylon, *Annual Report* (annual).

a nontradable bias in sectoral growth performance after 1977. The combined share of nontradable production (services plus construction), which varied between 46 and 50 percent during 1960–77, increased to about 60 percent during 1978–89.⁸

Savings and Investment

Average gross capital formation during the latter half of the 1960s rose to 16 percent from around 14 percent in the earlier period (table 3.6), but then fell sharply during 1970–77. This was followed by a massive increase in the investment level, which averaged more than 27 percent of GDP from 1978 to 1983 and then declined marginally to 24.6 percent during the 1984–89 period. The massive increase in domestic investment during the post-1977 period required large amounts of foreign capital because of slow growth of domestic savings. The domestic savings ratio changed little until the mid-1980s, when a significant increase was recorded.

The public sector share (including public corporations) in total annual gross capital formation increased from 48 percent to 52 percent between 1960–65 and 1971–77. Despite market-oriented policy reforms in 1977, this ratio further increased to 58 percent in 1978–83 because of aid-funded public sector infrastruc-

Table 3.6 Savings and Investment, 1960–89*(as a percentage of GDP)*

<i>Sector</i>	<i>1960–65</i>	<i>1966–70</i>	<i>1971–77</i>	<i>1978–83</i>	<i>1984–89</i>
Domestic savings	12.0	11.8	13.1	13.0	16.6
Investment	13.8	16.1	12.0	27.8	24.6
Foreign savings ^a	0.7	4.3	-1.1	14.8	8.0
<i>Composition of investment</i>					
Private sector	52.5	54.5	48.2	(42.5)	76.5 ^b
Public corporations	15.5	21.0	13.2	(33.5)	
Government and public enterprises	32.0	24.5	38.6	24.0	23.5

a. Represents domestic savings-investment gap.

b. From 1984 on the figure for the private sector and the figure for public corporations was combined.

Source: Appendix tables SA-2 and SA-3.

ture development projects. By far the largest share of public sector investment after 1978 went to the Mahaweli project.

Labor Force, Employment, Unionization, and Wage Formation

The census of 1981 showed an estimated labor force of about 5.0 million (or 34 percent of the total population). The pattern of labor force growth has reflected the combined impact of population growth and the resulting changes in the age structure, the increasing monetization of labor markets, and patterns of labor migration. The labor force grew at the average rate of 1.5 percent per year in 1953–63, 3.3 percent during 1963–71, and 2.7 percent in 1971–80. The slowdown in the last period was partly due to outmigration (Korale 1987). The distribution of the labor force continued to reflect the dominance of the agricultural sector. Some 46 percent of the labor force was still employed in agriculture in 1981, compared with 53 percent in 1953. Employment in industry increased from 12 percent to 16 percent during the same period (see table 3.7).

Yet a large proportion (about two-thirds) of the labor force is engaged in wage employment, a high figure for a developing country with a predominantly rural and agricultural population. One reason is that almost all employees in the plantation sector are paid employees. Furthermore, extensive cultivation of cash crops by smallholders and the relatively long exposure of Sri Lankan rural society to commercialization have made wage employment pervasive even outside the plantation sector. Labor force participation rates have shown a gradual decline in the 10–19 age group because of improved access to secondary and higher education. In the 15–19 age group the figure fell from 59.2 percent in 1946 to 42 percent in

Table 3.7 Sectoral Distribution of Employment, Selected Years, 1953–81
(percent)

<i>Sector</i>	<i>1953</i>	<i>1963</i>	<i>1971</i>	<i>1981</i>
Agriculture, forestry, fishing and hunting	52.9	52.6	50.4	45.9
Export agriculture	28.6	24.6	20.1	18.5
Domestic agriculture	22.9	26.6	28.7	27.2
Industry	12.1	12.4	13.4	16.1
Construction	1.9	2.7	3.1	4.2
Manufacturing	9.7	9.2	9.6	12.0
Services	28.4	29.5	28.0	31.3
Activities not adequately described	6.6	5.5	8.2	6.2

Source: Government of Sri Lanka, Department of Census and Statistics, *Statistical Pocket Book* (1983).

1981. On the other hand, female participation as well as male participation in the 25–54 age group has steadily risen. In general, participation rates are somewhat higher in the rural areas. This is markedly so in the case of women, due to high rates of female participation in the plantation sector (Korale 1987).

Some labor market segmentation arises from the significant differences in the ethnic composition of the work force. Caste barriers to labor mobility, on the other hand, are almost nonexistent, in contrast to the situation in other parts of the Indian subcontinent. Beginning in British colonial times, Sri Lanka's plantations employed a large proportion of immigrant South Indian laborers of Tamil origin. The majority of them were stripped of citizenship rights in 1948 and, through both legal and nonlegal barriers, effectively excluded from the wider labor market. Although some plantation laborers subsequently gained citizenship, in general their occupational mobility has been low. Linguistic and cultural barriers, as well as low levels of formal education, have restricted the movement of even those who have obtained citizenship rights into other areas of employment.

By the mid-1960s, concern was being expressed about the emergence of open unemployment. But it is difficult to assess the degree of the problem, since unemployment figures from underdeveloped and predominantly agricultural countries are known to be unreliable. Estimates of unemployment in the early 1960s ranged from around 10 to nearly 14 percent. Figures for the early 1970s suggested a deterioration of the employment situation. There was a marked improvement in the early 1980s following the trade liberalization reforms, but more recent figures suggest that a noticeable upturn in unemployment may have taken place in the latter part of the decade. Recorded unemployment tends to be higher among the relatively well-educated, many of whom seek employment in the public sector.

Trade Unions and Wage Formation

Sri Lanka has a long history of trade union organization and worker militancy (Jayawardena 1972). Trade unions first became associated with political parties in the 1920s. After the emergence of Marxist-influenced parties in the 1930s, trade union activities became closely associated with left-wing politics, giving a distinct political favor to much trade union activity. This close association with political parties influenced the evolution of the trade union movement, which often split along party lines. In the 1960s, most of the trade unions were dominated by the LSSP or the CP. The Ceylon Federation of Labor (CFL) and the Ceylon Mercantile Union (CMU), both linked to the LSSP, and the Ceylon Federation of Trade Unions (CFTU), linked to the CP, were the major umbrella organizations. However, their influence among plantation workers was relatively weak. After the disenfranchisement of Indian Tamil workers in 1948, they organized themselves into “nonpolitical” unions with a distinct ethnic character, of which the Ceylon Workers Congress (CWC) and the Democratic Workers Congress (DWC) were the largest.

The trade unions have been a powerful force in Sri Lankan political and economic life, but this strength has not always been reflected in traditional expressions of union power, such as collective bargaining agreements. This has led some observers, such as Fields (1986), to conclude that unions in Sri Lanka have had little influence on wage-setting. This view is based on an ignorance of the major channel through which trade union power was expressed. In Sri Lanka the effects of union power were most directly and strongly felt in their impact on the “social wage” in a country where consumer subsidies were of enormous significance until the early 1980s. The extension and defense of these subsidies were achieved through the mobilization of union strength. A major change in the post-1977 period has been the marked reduction in the industrial and political power of the trade unions (Rodrigo 1988).

Collective bargaining has not been a common system of wage adjustment in Sri Lanka, except in some of the highly skilled trades in the private sector. Major wage revisions in the government sector have usually occurred as a result of the recommendations of pay commissions appointed to inquire into the wage structure (Rodrigo 1983). Reviews of this kind took place in 1955, 1969, 1975, and 1982. In addition to these reviews, changes have also been made as a result of periodic cabinet decisions. Trade unions in the public sector have tended to be particularly well-organized, and union agitation over wages was undoubtedly a factor influencing the creation of the commissions and the implementation of their recommendations. Many cabinet decisions on wage increases may have been intended to forestall intensified union activity.

In the nongovernment sector the major institutional mechanism in wage determination has been Wages Boards, first established in 1941 under minimum wage legislation. The operations of these boards, comprising equal numbers of employer, government, and union representatives, have covered a large proportion of the workers in the nongovernmental sector. In industries that are not covered by

Wages Boards the commissioner of labor frequently has the power to fix minimum wages. Institutional mechanisms of arbitration and conciliation, with decisions binding on all parties, have been of particular importance in the urban sector. Collective agreements arrived at through direct bargaining between employer and employee organizations are often found in the banking and urban mercantile sectors. The government has been the effective employer of a large proportion of the work force even in the so-called nongovernmental sector (due to the large number of public corporations, including those in the plantation crop sector).

In general, the formal sector wage determination process has reflected the role of the state as the country's largest employer as well as the philosophy that state intervention to maintain industrial harmony is a legitimate government activity. Nonetheless, the pattern of wage changes has also reflected changes in the strength of the organized trade union movement. For example, a substantial wage increase in the plantation sector in 1984 was influenced significantly by the government's perception of a "need to avoid a restless situation among another minority community" (Rodrigo 1988:xiii).

Government policies on wages in the unorganized sector of the labor market, on the other hand, have been quite ineffective. Government legislation on minimum wages, for example, has had little or no effect on wages in the large informal services sectors, or in smallholder agriculture or small-scale industry.

Commodity and Factor Markets

As previous discussions have indicated, Sri Lanka's commodity markets have been subjected to extensive government intervention. This intervention has taken the forms of foreign trade taxes, various implicit and explicit subsidies, quantitative controls (most commonly on imports but sometimes on exports), price controls, controls on the physical movement of particular commodities, and regulations specifying compulsory sales to government procurement agencies.

The most extensive state presence in the primary commodity markets has been in the rice sector, where the government has been involved in the distribution of inputs, the purchase of paddy from farmers under a guaranteed price scheme, and distribution of the rice ration. The latter two functions had their origins in the war period but were continued in subsequent years. The distribution of subsidized inputs became particularly important after the rise in fertilizer prices in the aftermath of the oil price increases in the 1970s. The continuation of the paddy purchasing scheme in subsequent years was aimed at maintaining producer incentives by counteracting the downward pressure on rice prices through the provision of subsidized rice to consumers. Until the post-1977 reforms opened up the rice market, government purchases were made at a higher (guaranteed) price than the price in the open market, and generally at a price above the world price. Such purchases were used to provide some of the rice available to consumers.

Although the government's purchase price was usually higher than the market purchase price, there was large private sector involvement in the domestic paddy trade, since many farmers found it difficult to meet the quality standards set by the state procurement agency. Then, in 1972, the government granted monopoly procurement rights to the Paddy Marketing Board (PMB), which had been set up in 1971 to replace the Agrarian Services Department. This was an attempt to reduce the costs of providing the subsidized rice in the face of domestic supply setbacks, price rises in the open market, and steep increases in international prices. The creation of the PMB dislocated traditional marketing channels and created dissatisfaction among both producers and consumers because there was no increase in the purchases of the state agency (*Central Bank of Ceylon Annual Report—1975*). The monopoly was abolished in late 1975.

Since then, the role of the state has diminished, but domestic rice prices have continued to be influenced by the government through the release of imports into the market. On the supply side, too, government intervention has been important through the provision of research and extension facilities, subsidized inputs and credit, and investments in infrastructure, particularly irrigation. The input subsidies have been scaled down in recent years, but given the electoral strength of the country's rice farmers, it is unlikely that a withdrawal of the government from the rice market is on the horizon.⁹

The role of export taxes in the production of plantation crops is a continuing theme in this study and will be discussed in detail later. Here, we simply note that they were the most important source of government revenue for a long period of time, and that the progressive tax structure enabled the government to obtain a large share of any world price improvements. The state has also intervened in the domestic markets to a limited extent through the licensing of traders, and through the nationalization of the foreign-owned Agency Houses in 1971.

In general, there have been few direct price interventions in the domestic tea or rubber markets, but the situation has been different in the coconut sector. Coconuts are an important commodity in Sri Lanka, where they are consumed in the form of fresh nuts and as coconut oil, the most widely used cooking oil in the country. Coconut exports have usually been processed products, especially copra, desiccated coconut, and coconut oil. Government intervention in the coconut sector has been motivated by factors similar to those operating in the rice sector—that is, they have been aimed at maintaining “reasonable” prices for both producers and consumers. In the case of coconuts there have been the additional objectives of securing government revenues and export earnings. Such interventions were also based on recognition of significant monopsonistic elements in the markets—for example, the relatively small number of oil millers. Until the 1970s, intervention was mainly aimed at stabilizing producer prices. A floor price scheme established in 1968 banned exports below a stipulated minimum, and in 1972 the largest private oil mill was commandeered by the government in an attempt to ensure better producer prices in the copra market. This was followed in late 1972 by a scheme whereby the government bought oil at a specified price from the millers

and sold it to exporters at a price that was based on the world price. Throughout this period, coconut production was relatively stagnant, and rising domestic consumption was eroding the exportable surplus. A supply shortfall in 1973 due to drought and insect attack resulted in a steep rise in the prices of fresh nuts used for domestic consumption. The government then banned oil exports to dampen prices. In subsequent years such bans were resorted to by the government whenever domestic nut prices rose steeply, but the bans did not extend to desiccated coconut exports. (For an analysis of government policies during this period, see de Silva 1979.) During the mid-1980s a substantial liberalization of export controls was implemented.

Supply-side intervention in the plantation crop sector has included provision of subsidized inputs, research and extension facilities, and replanting grants, the latter two activities funded by levies on exports. Similar interventions have been made in the case of many minor agricultural crops, particularly those designated as nontraditional export crops. However, their overall impact is likely to have been relatively minor.

The extensive array of quantitative restrictions on imports, the establishment of state-controlled domestic marketing monopolies to distribute rationed goods at regulated prices, and the concomitant development of black markets affected most consumer goods markets from the early 1960s until the late 1970s. The consequences are analyzed in greater detail in later chapters.

The Financial Sector

In the years immediately following independence, Sri Lanka's commercial banking sector was dominated by foreign banks.¹⁰ Of the twelve commercial banks, only two were indigenous. Of these two, the Bank of Ceylon was far more important than Hatton Bank Ltd. The commercial banks were mostly engaged in financing the plantation sector and foreign trade, and were concentrated in Colombo. Under these circumstances, it is hardly surprising that the informal sector was the main source of funds for most of the population to the extent that they utilized capital markets at all. Typically, the informal sector provided short-term credit at considerably higher rates of interest than those prevailing in the organized sector (see Tambiah 1963 and Tilakaratna 1963).

The major turning points in the evolution of commercial banking were the nationalization of the Bank of Ceylon and the launching of a new state-sector bank, the People's Bank, in 1961. These actions coincided with the imposition of exchange rate controls which almost completely insulated the domestic financial sector from international capital markets. The nationalization inaugurated a period in which credit allocation became a major instrument of government investment policies, particularly in terms of achieving sectoral investment goals. Interest rates were sector-specific, with priority sectors having substantially lower rates. Government initiatives taken during this period set the stage for the financial repression that prevailed until the late 1970s. There was also a drive to expand banking

services, particularly to the rural sector, and between 1960 and 1965 the number of branch offices rose from 45 to 97. All of this expansion was carried out by the two state banks, which by 1965 accounted for two-thirds of all bank deposits (table 3.8).

In addition to the commercial banks, there were three savings banks at the time of independence—the Ceylon Savings Bank (established in 1932), the Post Office Savings Bank, and the National Savings Movement (1944). These three institutions were amalgamated in 1972 to form the National Savings Bank (NSB), which by the mid-1970s accounted for over 50 percent of total savings and time deposits mobilized through institutional sources. There was also an Employee's Provident Fund (EPF), established in 1958 and administered by the Central Bank. The NSB and EPF have been useful sources of captive funds for the government.¹¹

Sri Lanka's first development bank, the Development Finance Corporation of Ceylon (DFCC), was established in 1955 to assist in the establishment of private enterprises in industry and agriculture by providing medium to long-term financing. Its objective was to encourage greater equity financing rather than direct loans, with a view to encouraging companies to meet their capital requirements by issuing shares.

Other important financial institutions in the 1960s included private finance companies and insurance companies. The finance companies utilized share capital and bank borrowings, and acceptance of deposits from the public was rare until the late 1960s. Their major activity was the financing of purchases of consumer durables. Up until 1961 the insurance industry was composed of some 122 private

Table 3.8 Financial Market Institutions, Percentage Distribution of Assets

<i>Institution</i>	<i>1965</i>	<i>1970</i>	<i>1977</i>	<i>1981</i>	<i>1984</i>
Commercial banks ^a	48.7	51.5	58.8	62.4	57.3
Other deposit-taking institutions	18.4	21.5	17.8	16.4	21.3
FCBUs	—	—	—	3.1	4.6
National Savings Bank	18.4	19.3	16.0	11.6	13.0
Finance companies ^b	—	2.2	1.9	1.7	3.7
Development finance institutions	2.8	1.3	3.1	3.1	—
National Development Bank ^c	—	—	—	0.4	0.6
Development Finance Corporation	0.8	1.0	0.7	1.9	1.7
Nonbank financial institutions	29.2	24.2	22.1	18.1	18.3
State-owned provident funds	18.9	17.6	15.2	12.2	12.4
State-owned insurance companies	0.9	1.2	2.3	1.8	1.2
Total	100.0	100.0	100.0	100.0	100.0
(millions of rupees)	3,718	6,112	17,217	50,598	95,901

a. Excluding Foreign Currency Banking Units (FCBUs).

b. This figure relates to only those companies which report their assets to the Central Banks.

c. Figures for 1965 and 1970 show the combined deposits of Post Office Savings Bank, Ceylon Savings Bank, and the Savings Certificate Fund, which were amalgamated in 1973 to form the National Savings Bank.

Source: Khatkhate (1980), supplemented with various issues of Central Bank of Ceylon, *Monthly Bulletin of Statistics*.

companies in a highly competitive market (Karunatilake 1986). Then a state-owned Insurance Corporation of Ceylon (ICC) was established and given a monopoly on life insurance. In 1964 it was granted a monopoly on all other forms of insurance as well.

If the financial system was at a relatively early stage of development in the 1960s, the equity market was practically nonexistent. Although company shares and stocks had been traded in Sri Lanka since the late 19th century, the business was traditionally carried out by commodity brokerage firms as a part of their general commodity trading under an institutional set-up devised by the Share Brokers Association. The activities of the share market took the form of direct dealings among brokers. Historically, plantation companies accounted for more than 90 percent of all shares listed for trading, but this began to change in the early 1960s as the available shares of industrial, financial, and commercial companies started to increase.

Nonetheless, the market was in the doldrums during much of the period between 1960 and 1977, and annual share turnover declined from 19.8 million rupees in 1960 to 7 million rupees in 1976 (*Ceylon Brokers' Association—1977*). Constraints on foreign exchange remittances dissuaded foreign companies from selling shares, and only a tiny minority of Sri Lankans owned any shares at all (Karunatilake 1986).

Issuance of bonds became an important source of long-term financing for the government in the mid-1950s, but these bonds accounted for a relatively small fraction of total public debt until the late 1970s. Sales of government securities were handled by the Central bank, and the bulk of the purchases was made by institutional investors. Treasury bills were mainly absorbed by the Central Bank. As with government securities, there was little or no private investor participation in this market, and the rate of interest was generally below market rates. There was no secondary market.

Financial sector reforms in 1978 (chapter 2) had a major impact on the system. Fourteen foreign banks opened branches in Colombo in 1979, bringing the total number of commercial banks operating in Sri Lanka to 21. These new banks aggressively pursued customers, and their share of total bank deposits increased from 5 percent in 1980 to 15 percent in 1983. The share of commercial banks in total assets of capital market institutions declined after 1981 because of rapid expansion in the operations of nonbank financial institutions, notably finance companies, foreign currency banking units (FCBUs), leasing companies, and the Development Finance Corporation. Although the domestic capital market's ties to world capital markets have improved via the foreign banks and the FCBUs, controls on capital movements have interfered with market integration.

The share market gained strength in the aftermath of financial and trade liberalization in 1977. During the period 1980–84 there were eighty-seven new issues of company shares with a total value of 2,307 million rupees. By contrast, there were only twelve new share issues during the period 1960–77, with a value of about 230 million rupees. By the latter part of the 1980s there were about 170 companies listed on the Sri Lankan stock exchange.

The share market in Sri Lanka remained essentially a primary market in the 1980s, and more than 90 percent of sales consisted of purchases of new issues. Hence, the total volume of transactions in a given period was only a small fraction (about 6 to 10 percent) of the total value of listed shares. Debentures and notes were not listed or traded. It has been estimated that only about 7,000 people in Sri Lanka hold shares in companies listed on the stock exchange (Karunatilake 1986). A large proportion of all shares is in the hands of closely held companies, and the tendency of these companies to withhold profits from shareholders makes it difficult for a secondary market to emerge.

The issuing of securities has been an important source of long-term financing for the government since the mid-1950s, and reliance on such securities took a sharp upturn after 1977. By 1985 the value of government securities outstanding was 36,570 million rupees, compared with 6,963 million rupees in 1976. The value of securities as a percentage of total public debt increased from 16 to 28 between these

Table 3.9 Interest Rates, 1965-87

Year	National Savings Bank		Commercial bank	
	deposit rate	Deposit rate	Deposit rate	lending rate
1965-70	3.7 (-2.4)	3.7 (-2.4)	9.0 (-2.9)	
1971-76	7.2 (-8.4)	5.0 (-11.1)	8.5 (-7.1)	
1977-83	14.9 (1.3)	13.8 (0.2)	16.3 (2.5)	
1984-87	14.2 (5.2)	9.8 (0.1)	20.2 (12.9)	
1977	11.1 (8.1)	10.6 (7.7)	11.3 (8.4)	
1978	12.6 (2.3)	11.4 (1.1)	12.8 (1.5)	
1979	12.1 (-5.1)	11.8 (-5.3)	13.8 (-3.2)	
1980	17.0 (2.3)	17.5 (2.9)	17.2 (2.6)	
1981	17.2 (0.3)	17.8 (1.0)	8.4 (1.6)	
1982	17.8 (-5.1)	13.6 (-9.3)	20.0 (-2.9)	
1983	16.5 (5.1)	14.1 (2.7)	20.6 (9.2)	
1984	16.7 (4.6)	12.6 (0.5)	20.5 (8.4)	
1985	14.3 (3.3)	11.2 (0.2)	20.1 (9.1)	
1986	12.8 (8.1)	7.5 (0.3)	20.3 (13.1)	
1987	12.8 (4.8)	7.4 (-0.5)	19.8 (11.9)	

a. In each column, the first figure indicates the nominal rate and the second (bracketed) figure the real rate. The deposit rate is the weighted average of savings deposit and one year fixed deposit rates. The lending rate is the weighted average rates of loans classified by securities. The real rate is the difference between the current nominal rate and the inflation rate as measured by the GDP deflator (non-services) for the previous year.

b. Annual average.

Source: Columns 1 and 2: compiled using data from Central Bank of Ceylon, *Review of the Economy* (annual). Column 3, Central Bank, *Monthly Bulletin of Statistics* (various issues).

two years. This may have been due in part to the fact that the maturity period on government issues was shortened from ten or twelve years to three years, and the rate of interest on the securities was increased from below-market level to 16 percent.

In April 1981 the Central Bank inaugurated a secondary market in Treasury bills. Under this arrangement the Central Bank participates in the market by buying and selling bills with varying maturities at interest rates that are determined day to day in light of market rates. Secondary market transactions increased from 7,542 million rupees in 1981 to 39,587 million rupees in 1984, the commercial banks being the major participants. Participation in the secondary market allowed the Central Bank to prevent sharp fluctuations in short-term interest rates and to siphon off excess liquidity in the banking system (Hettiarachchi 1986).

Financial Intermediation and Credit

Throughout the period 1960–77, pervasive restrictions on the financial system and negative real interest rates produced a process of financial disintermediation (tables 3.9 and 3.10).¹² The degree of financial intermediation, as measured by the M3/GDP ratio, declined or remained stagnant in most years. By the mid-1970s, this ratio was below the level recorded in the early 1960s.

Financial market reforms in 1977 were followed by a remarkable improvement in financial intermediation. The M3/GDP ratio rose from an average level of

Table 3.10 The Behavior of Real Monetary Aggregates

<i>Year</i>	<i>M1^a</i>	<i>M2^a</i>	<i>M3^a</i>	<i>M1/GDP (percent)</i>	<i>M2/GDP (percent)</i>	<i>M3/GDP (percent)</i>
1960	61	37	37	17	22	29
1965	87	55	53	20	26	33
1970	83	65	62	14	22	29
1975	59	43	47	12	17	25
1977	69	54	55	15	24	32
1978	82	71	73	14	26	34
1979	94	87	89	15	29	38
1980	100	100	100	14	30	38
1981	96	109	108	12	31	40
1982	107	131	133	12	31	40
1983	116	137	141	12	31	40
1984	113	138	145	10	28	38
1985	127	154	165	12	30	41
1986	136	154	168	12	28	40
1987	146	161	174	13	30	41

a. At constant 1980 prices (1980=100).

Source: Athukorala and Rajapatirana (1990); data in appendix table SA-21.

29 percent in the 1970–77 period to 34 percent in 1978 and stabilized at around 40 percent in the 1980–87 period. While M1 continued to increase in real terms, however, its ratio to GDP declined. This suggests a shift in household asset portfolios from cash holdings to savings and time deposits in response to favorable interest rates (Athukorala and Rajapatirana 1990).

Table 3.11 shows the distribution of credit in the public sector, public corporations, and the private sector, and the distribution of credit to the public sector by lending institutions. The government share of total domestic credit increased from 58 percent in 1970 to 64 percent in 1979, and then declined to about 40 percent in 1985. Throughout the period, almost half of the government's domestic credits came from the Central Bank, and most of the remainder from the two captive lenders, the NSB and the EPF.

Table 3.12 presents data on the sectoral distribution of commercial bank credit. Commerce, including foreign trade, accounted for about 50 percent between 1965 and 1984. Credit to industry, the second largest category, stabilized at around 25 percent from 1970 to 1984. Several trends can be observed in the pattern of sectoral credit allocation after 1977. First, a decline in agriculture's share of credit, second, a rise in housing's share of credit, and third, a fall in consumers' share of credit. Loans to the industrial sector accounted for the bulk of loan approvals of the long-term credit institutions.

Table 3.11 Total Credit Extended By Non-Central Bank Financial Institutions, Selected Years, 1977–85

(1980 prices)

<i>Sector</i>	<i>1977</i>	<i>1979</i>	<i>1981</i>	<i>1983</i>	<i>1985</i>
Total credit	15,361	25,669	33,990	43,963	47,798
(millions of rupees)					
Government, net (percent)	49.1	40.7	33.0	32.5	32.0
Public corporations (percent)	13.4	15.1	12.3	7.3	6.0
Co-operatives (percent)	10.0	8.7	3.5	3.1	1.8
Private sector (percent)	27.5	35.5	51.2	57.1	60.2
Government credit					
sources, net					
(millions of rupees)	7,426	10,465	11,241	14,331	15,291
Commercial banks (percent)	0.7	-2.3	0.5	-0.9	-1.9
National Savings					
Bank (percent)	40.9	46.7	44.7	51.7	57.9
Employee Provident					
Fund (percent)	40.7	43.1	46.2	45.8	56.7
Insurance companies (percent)	16.6	14.6	12.2	7.0	6.2

Source: Central Bank of Ceylon, *Review of the Economy* (annual).

Table 3.12 Commercial Bank Loans to Private and Public Sector Corporations

<i>Distribution</i>	<i>1970</i>	<i>1975</i>	<i>1977</i>	<i>1978</i>	<i>1979</i>	<i>1980</i>	<i>1981</i>	<i>1982</i>	<i>1983</i>	<i>1984</i>	<i>1985</i>
Total loans ^a	6,226	6,341	7,222	11,491	13,769	17,136	18,916	21,780	23,273	22,241	24,476
Index (1980=100)	36	37	42	67	80	100	110	127	136	130	143
Distribution by sector (percent)											
Tradable sectors	40.0	36.5	40.6	43.1	40.7	35.6	35.2	36.6	36.5	33.8	33.0
Agriculture	13.1	14.1	17.2	16.0	14.8	13.2	13.2	12.1	10.9	9.2	9.3
Industry ^b	26.9	22.4	23.4	27.1	25.9	22.4	22.0	24.5	25.6	24.6	23.7
	(21.6)	(18.6)	(21.1)	(24.3)	(22.3)	(18.4)	(17.6)	(19.3)	(20.7)	(19.8)	(19.0)
Nontradable sectors ^c	60.0	63.5	59.4	59.4	59.3	64.4	64.8	63.4	63.5	66.2	67.0
Maturity structure (percent)											
Short-term	58.9	74.6	77.5	74.0	75.0	70.2	68.4	68.9	71.0	72.2	70.6
Medium-term	28.7	19.3	16.5	20.4	19.4	21.2	20.4	22.2	20.4	18.6	19.4
Long-term	12.3	6.1	6.0	5.5	6	8.6	10.2	8.9	8.6	9.2	10.0

a. Millions of rupees at 1980 prices.

b. Percentages of loans to manufacturing are given in parentheses.

c. Sum of loans for commercial, financial, housing and consumption.

Source: Central Bank of Ceylon, *Monthly Bulletin of Statistics* (various issues).

Informal Money Markets

In Sri Lanka, as in many other developing countries, the informal money market has played a very important role in the provision of credit, though its importance has been declining over time because of the gradual expansion of the formal market. In 1981–82, about 60 percent of total household borrowing (which includes borrowing by informal businesses and cottage industries) was provided by the informal market, as against 80 percent in 1973. The use of informal sources of credit is by no means confined to households and small businesses. It is believed that the Pettah money market (the informal money market in Colombo) has been an important source of funds to many commercial enterprises needing very large amounts of money.

The available evidence suggests that the informal money market in Sri Lanka is segmented, noncompetitive, and not well-integrated with the formal market. Informal loans come from a wide range of sources, in contrast to the general tendency to think of informal credit as synonymous with pure money lending. The share of pure moneylenders in total informal borrowing of households seems to be less than 25 percent. About one-third of the borrowed money comes from friends and relatives. The rest is mostly related to land tenure relations and the systems of product marketing and consumer credit. Most of the credit supplied by moneylenders is extended at interest rates that are much higher than those of institutional credit, while credit from the other sources is granted either free of interest or at rates much below institutional rates. The data indicate that informal credit is obtained mostly for “nonproductive” purposes. A major failing of the informal system has been the almost complete absence of lending for long-term investment, such as the planting of long-gestation crops (Jayasuriya, Barlow, and Shand 1981).

Price Movements

Table 3.13 indicates variations in the annual rate of inflation in terms of four price indices: the Colombo Consumer Price Index (CCPI) as adjusted by Bhalla (1987), the GDP deflator (GDPD), the Wholesale Price Index (WPI), and the Central Bank Consumer Price Index (CBCPI).¹³ Up until the early 1960s the annual inflation rate remained around two percent. During this period the domestic money supply increased rapidly because of the increased reliance of the government on the Central Bank for deficit financing. Yet the economy was able to meet the resultant additional demand through an increased supply of imported goods, drawing upon foreign reserves accumulated during the Korean War boom (1950–52) and the tea price boom (1954–55) (Gunasekara 1963). By the early 1960s, when a stringent import-control regime evolved in response to depletion of foreign reserves, monetary expansion began to bring about increases in the price level.

Inflationary pressure was further aggravated in the early 1970s by domestic supply bottlenecks resulting from a scarcity of imported intermediate goods and increases in import prices brought about by the first oil price shock. After 1977, significant depreciation of the external value of the rupee and domestic demand

Table 3.13 Changes in the Price Level, 1950–89*(annual percentage changes)*

<i>Year</i>	<i>CCPI</i>	<i>GDPD</i>	<i>WPI</i>	<i>CBCPI</i>
1950–59	0.7	2.2	—	—
1960	-1.9	7.3	—	—
1961	1.6	-1.5	—	—
1962	1.4	-0.4	—	—
1963	2.4	1.3	—	—
1964	3.1	1.1	—	—
1965	0.3	-2.2	—	—
1966	-0.2	3.5	—	—
1967	2.2	2.9	—	—
1968	5.8	14.7	—	—
1969	7.4	8.9	—	—
1970	5.9	-0.2	—	—
1971	2.6	3.5	—	—
1972	6.2	7.1	—	—
1973	9.9	15.6	—	—
1974	12.1	22.9	—	—
1975	6.7	8.0	3.0	3.0
1976	1.2	6.3	8.6	3.8
1977	1.2	20.3	20.9	15.0
1978	11.8	7.6	15.8	8.9
1979	10.9	8.8	9.5	18.6
1980	26.2	21.5	33.7	37.1
1981	17.9	16.0	17.0	23.8
1982	10.8	17.1	5.5	11.1
1983	13.9	14.5	24.9	11.3
1984	16.6	17.1	25.6	—
1985	1.4	0.9	-15.2	—
1986	7.9	5.8	-2.9	—
1987	7.7	7.0	13.3	—
1988	13.9	11.5	17.7	—
1989	11.6	9.7	9.0	—

Notes: CCPI—Colombo Consumer Price Index; GDPD—Gross Domestic Product Deflator; WPI—Wholesale Price Index; CBCPI—Central Bank Consumer Price Index (unpublished).

Source: Appendix table SA-7.

pressure generated by the massive investment in the public sector and migrant worker remittances added to inflation. Whatever the price index used, the average annual inflation rate during the 1980s was almost twice that in the 1970s. Sri Lanka, however, has never experienced a period of hyperinflation. Even allowing for the deficiencies of the indices and the acceleration of the inflation rate in the 1978–84 period, strong inflationary tendencies did not become entrenched in the econo-

my. Thus, it can still be considered a low-inflation country by average developing country standards (Corden 1991).

The attitudes of policymakers of varying political persuasions toward inflation have been remarkably similar, and strong anti-inflation attitudes have also been entrenched in the Central Bank, which inherited a legacy of monetary conservatism from the British.

The Role of the State

The direct role of state enterprises in the economy has been quite extensive, in terms of both policy formation and direct impact on fiscal revenues and expenditures. So far, however, no attempt has been made by official Sri Lankan agencies to determine the components of total value added in the public and private sectors. But value-added disaggregations are available for 1961, 1966, and 1974, thanks to a research project sponsored by the Canadian International Development Research Corporation (IDRC) in the mid-1970s (Lakshman 1979). As shown in table 3.14, the IDRC found that public enterprises accounted for 5.7 percent, 7.3 percent, and 12.2 percent of Sri Lanka's GDP in those three years. If allowance is made for the second stage of the takeover of plantations in 1975 and the takeovers that occurred under the Business Undertakings Acquisition Act during 1972–76 (discussed in chapter 2), the proportion would no doubt have exceeded 15 percent by the end of the United Front regime in 1977.

The importance of the public sector has been greatest in the finance and insurance sector, where the public enterprise share rose from 50 percent in 1960 to 94 percent in 1974. This took place during a period when the activities of foreign-owned banks had been severely restricted through discriminatory legislation. According to Central Bank data, the share of the two state-owned banks (the Bank of Ceylon and the People's Bank) in total commercial bank assets increased from 35 percent in 1965 to 74 percent in 1974. The very high public sector share in the utility services sector was due to the monopoly position of the Electricity Board. The public enterprise shares of the transport and manufacturing sectors increased from 36.5 to 45.6 percent, and 1.8 to 33.9 percent, respectively, between 1961 and 1974. Although the public sector share in wholesale and retail trade declined from 5.4 percent to 4.1 percent between 1961 and 1966, it then increased to 10.6 percent in 1974.

The public sector share of manufacturing value added declined from 33 percent in 1974 to 29 percent in 1981 (Athukorala 1986). Judging by the public sector manufacturing output index (table SA-4), we surmise that this declining trend persisted in subsequent years. There was also a significant decline in state involvement in foreign trade. The liberalization of import trade and the removal of various restrictions on internal trade in 1977 resulted, in all likelihood, in a significant decline in the public sector share of wholesale and retail trade as well.

With regard to the other sectors, though, there is no evidence that suggests any decline in public sector involvement. The liberalization measures that expanded the

Table 3.14 Percentage Contribution of Public Enterprises to Sectoral Value Added and Total GDP

<i>Sector</i>	<i>1961</i>	<i>1966</i>	<i>1974</i>
Agriculture, forestry, hunting and fishing	0.1	0.1	0.5
Mining and quarrying	0	0	5.5
Manufacturing	1.8	7.6	33.9
Electricity, gas and water	88.9	90.9	93.5
Construction	0	4.2	6.8
Wholesale and retail trade	5.4	4.1	10.6
Transport, storage and communication	36.5	39.0	45.6
Finance and insurance	49.6	52.4	94.5
Other services	—	1.2	1.0
Gross domestic product	5.7	7.3	12.2

Source: Lakshman (1979), table 4.3.

role of private banks in commercial banking and the activities of private sector finance companies seem to have been counterbalanced by government involvement in the services and construction sectors. In short, the “open economy” strategy adopted in 1977 did not produce a significant reduction in the role of public enterprises.

Such enterprises appear to have accounted for about 6 percent of total employment by 1973 (Lakshman 1979, table 7.6). With the nationalization of plantations, this would have increased to about 8 percent by 1976. The public sector share of total employment in the “organized” manufacturing sector increased from 25 percent in 1971 to 51 percent in 1979, but then declined to 39 percent in 1982. At least a part of this relative decline can be attributed to the growth of the mainly privately owned garment industry. By the mid-1980s, more than 40 percent of all paid employees in the country were in the public sector (Fields 1986). This figure is unlikely to have changed much in the latter part of the decade.

Fiscal Operations

Table 3.15 presents summary data on government fiscal operations. Up until 1977, current expenditures accounted for about 75 percent of total expenditures, but the share then varied from 45 percent (in 1978) to 59 percent (in 1985). This was due to the rapid expansion of public investment referred to earlier, rather than to any significant decline in the absolute level of current expenditures.

The composition of current expenditures demonstrates the major role of welfare expenditures in government fiscal operations. Combined expenditures (current and capital) on social welfare (mostly health, education, and food subsidies) accounted for about 40 percent of total government expenditures annually

Table 3.15 Summary of Fiscal Operations, 1950–89
(percentage of GDP)

Year	Revenue	Total expenditures	Recurrent expenditures	Government savings (current account surplus/deficit)	Budget deficit	Expansionary impact of fiscal operations (bank borrowing for deficit financing)
1950	21.8	23.2	—	1.4	—	—
1955	21.6	18.9	—	2.7	—	—
1960	22.5	29.6	—	7.1	—	—
1966	23.6	32.4	24.0	-0.3	8.8	1.5
1970	20.7	29.4	20.1	0.5	8.7	3.2
1971	21.5	30.2	21.8	-1.2	9.7	1.6
1972	22.2	31.5	23.0	-0.7	9.2	0.8
1973	22.5	30.4	21.5	0.9	7.9	0.3
1974	20.5	27.4	19.3	1.2	6.8	0.1
1975	19.7	30.2	20.0	0.2	10.3	0.8
1976	20.4	33.2	19.8	0.6	12.7	2.3
1977	19.2	28.1	17.1	1.5	8.8	-2.3
1978	28.8	46.5	25.7	3.1	17.7	0.4
1979	25.5	43.2	23.1	2.4	17.6	1.2
1980	22.6	48.7	21.2	0.3	21.6	10.3
1981	20.4	39.1	20.1	0.2	18.7	4.6
1982	19.4	41.3	21.9	-2.5	21.0	5.2
1983	22.6	42.0	21.5	1.1	19.4	0.4
1984	26.9	38.3	20.7	6.3	11.4	0.5
1985	25.0	44.7	22.4	2.5	19.7	0.8
1986	22.8	33.0	18.9	1.8	12.2	1.7
1987	23.8	32.5	20.1	1.3	11.1	1.8
1988	21.7	34.3	20.7	-2.0	15.6	4.7
1989 ^a	24.1	31.6	22.0	-0.4	-10.0	-0.4

a. Provisional.

Source: Appendix table SA-10.

between 1960 and 1977 (table 3.16). Food subsidy expenditures were the largest single item, accounting for about 40 percent of all welfare expenditures.

In 1978, however, the food subsidy was abolished for nearly one-half of the population, and the system of providing specified quantities of food at subsidized prices was replaced by a food stamp scheme targeted at families with less than a specified amount of monthly income (initially set at 300 rupees). Because of these changes, food subsidy expenditures as a share of total expenditures declined from 16 percent in 1977 to a mere 0.2 percent in 1985. The real value of food stamps fell steeply, since their nominal value was not adjusted for inflation (Ravallion and Jayasuriya 1988). In recent years the fastest-growing category of government expenditures has been transfers (mostly capital transfers) to public enterprises. As Lal and Rajapatirana (1989) have pointed out, the increase in these transfers outweighed the expenditure reduction resulting from curtailment of food subsidies.

Table 3.16 Social Welfare Expenditures

Year	Percentage of total government expenditures	Percentage of GDP	Category		
			Education	Health	Food
1955	33.9	6.4	46.6	31.4	10.2
1960	33.3	9.8	45.3	24.3	18.3
1965	44.9	13.6	35.1	16.5	44.2
1970	37.5	12.4	43.2	18.1	42.0
1977	30.4	8.1	32.9	16.7	37.8
1980	8.5	3.8	37.6	18.1	40.1
1982	8.1	3.2	45.3	20.3	28.1
1985	7.8	3.1	46.7	21.6	23.5

Source: Central Bank of Ceylon, *Review of the Economy* (annual).

Government expenditures in the 1950s amounted to about 20 percent of GDP and then rose to around 30 percent during the period 1960–77. After 1977 the figure rose to about 45 percent. Government revenues also increased, but at a slower rate. Throughout the period 1959–85, total revenues as a ratio of GDP remained in the narrow range of 20 to 25 percent. The outcome, naturally, was increasingly larger budget deficits.

Table 3.17 sets out data showing the changing pattern of government revenues for the period 1959–85. During this period, taxation accounted for 80 to 89 percent of total revenues, the balance coming from a variety of other sources, such as receipts from trading enterprises (five to eight percent), income from investments, sales of capital goods, and land rents. As in most other developing countries, a striking feature of Sri Lanka's tax structure is the dominance of indirect taxes. The contribution of these taxes to total tax revenue has varied from 78 to 83 percent.

Among indirect taxes, export and import duties have historically been the largest single source of revenue. In the 1950s they contributed 56 to 62 percent of all revenues and then declined to about 25 percent by the mid-1970s. Export taxes

Table 3.17 Source of Government Revenues, 1950–85

Source	1950–59	1960–69	1970–77	1978–83	1984–85
Export duties	29.3	15.3	13.1	19.3	7.9
Import duties	28.5	27.5	14.7	18.5	22.3
Other taxes	38.3	47.2	51.5	58.0	63.3
Nontax revenue	3.9	10.0 ^a	20.7 ^a	4.2	6.5

a. Includes receipts from Foreign Exchange Entitlement Certificates (1968–77).

Source: Central Bank of Ceylon, *Review of the Economy* (annual).

declined because of unsatisfactory revenue growth for exports of tea and rubber after the mid-1950s, while import taxes fell because of slow growth of imports and the virtual elimination of “nonessential” items from the import list (Athukorala and Huynh 1987). However, revenues from taxes on foreign trade continued to remain larger than those from domestic sources, owing to the FEECS. Following the 1977 reforms, the combined share of export and import duties in total revenue rose sharply, reflecting the immediate impact of exchange rate depreciation and a sudden surge of imports to meet pent-up demand. Since then, the percentage has come down to around 25 to 30 percent.

Export duties have been levied mainly on tea, rubber, and coconut products. As mentioned earlier, the duty lists were based on a sliding scale that substantially reduced gains to producers in periods of high prices. The immediate impact of the devaluation of 1977 was to raise the rupee prices of these exports, and this resulted in large revenue gains to the government. Substantial changes in the export crop taxation system were implemented in the 1980s, reducing the tax burden on those industries. The reduction in tax rates, combined with the stagnant volume of the main export crops, reduced the share of these taxes in total government revenue in the latter part of the 1980s. As a part of export promotion, duties on exports of most of the minor agricultural products were either sharply reduced or abolished during the period 1978–80. As a result, the combined share in total export tax revenue of taxes on minor exports declined from 10.4 percent in 1977 to 5.5 percent in 1985. There were no taxes on manufactured exports during the study period.

Revenues from taxes on domestic production and trade as a share of total tax revenues expanded rapidly in the past two decades. Since the early 1980s this share has exceeded that of taxes on foreign trade. The Business Turnover Tax (introduced in 1964) has been the most important domestic production tax.

Revenues from direct taxes ranged from 17 to 22 percent of all revenues during the period under study. This relatively low figure reflected the underdeveloped state of the economy and the weaknesses of the tax collection system. Among direct taxes, the corporate income tax is the most important. Its share of total tax revenues has remained in the range of 10 to 13.4 percent over the past decade. The relative share of taxes on personal income showed a mild declining trend over the same period, from five percent in 1974 to four percent by 1985. Despite the resurgence of private business activity after 1977, corporate income taxes failed to show buoyancy. That may be partly due to the wide array of tax exemptions that were offered to private enterprise, but tax evasion may have been equally responsible. A study conducted during the early 1970s estimated that the loss of income tax revenue due to evasion could be as high as 60 percent of the total collected annually. There is little evidence that there has been a significant improvement in the efficiency of tax collection since then.

Foreign Trade and Balance of Payments

The modern Sri Lankan economy has been heavily trade-dependent. At the time of independence the trade dependence ratio (TDR), or total imports and exports of goods and nonfactor services as a share of GDP was 70 percent and remained virtually unchanged throughout the 1950s (table 3.18). From then up to 1977 it declined secularly, reflecting the combined impact of sluggish export performance and stringent import controls. Following trade liberalization in 1977 it increased dramatically, reaching 83 percent in 1980, and then declined to about 65 percent on average during the 1980s. Throughout the postindependence period the level of the TDR has been dominated by the behavior of imports; the exports-to-GDP share has been either stable or declining. In particular, the increased openness of the economy during the 1977–89 period showed itself almost entirely in a surge in imports rather than in export dynamism.

Table 3.19 provides data on the changing composition of foreign exchange receipts. In the 1950s and 1960s, commodity exports accounted for more than 90 percent of total foreign exchange receipts. Earnings from tourism and remittances by migrant workers then began to make a significant contribution. The Ceylon Tourist Board was established in 1966, and tourism then became one of the fastest-growing sectors of the economy until ethnic conflict in 1983 brought its growth to a halt.¹⁴ Even in 1985, when the industry was already in decline, the share of re-

Table 3.18 Trade Dependence: Imports and Exports as a Percentage of GDP

<i>Year</i>	<i>Ratio of imports to GDP</i>	<i>Ratio of exports to GDP</i>	<i>Ratio of imports and exports to GDP</i>
1950	31.8	38.3	70.1
1955	35.7	35.5	71.2
1960	31.5	28.2	59.7
1965	25.6	25.5	51.1
1970	17.6	15.3	32.9
1975	20.7	15.2	35.9
1977	18.1	19.1	37.2
1980	54.5	28.3	82.8
1983	45.2	23.0	67.1
1986	35.4	23.8	59.2
1989	37.2	27.3	64.5

Note: Exports and imports include both goods and nonfactor services. Ratios are estimated using current price data.

Source: Central Bank of Ceylon, *Review of the Economy* (annual) and *Annual Report* (annual).

Table 3.19 Composition of Current Account Receipts in the Balance of Payments
(percent)

Year	Commodity exports	Services total	Travel	Private transfers ^a	Public transfers	Total (SDR mn)
1950	94.3	4.2	—	—	—	314
1955	94.3	4.8	—	—	—	421
1960	93.8	5.4	—	—	—	402
1970	83.3	13.5	1.9	-1.2	4.4	341
1975	77.7	11.2	3.1	0.3	10.7	597
1980	71.2	11.1	6.1	9.3	8.4	837
1985	57.1	18.9	8.3	14.9	9.1	1,609
1987	63.1	15.7	3.9	12.8	8.4	2,053
1989	60.6	17.3	3.1	13.4	8.7	1,776

a. Composed mostly (95 percent or more) of remittances of Sri Lankan workers working overseas.
Source: Compiled from Central Bank of Ceylon, *Annual Report* (annual).

ceipts from tourism in total current account receipts was eight percent, as against two percent in 1970. But during the late 1980s the government was compelled to provide considerable relief to the tourist industry, which suffered from massive excess capacity and found itself unable to service the debts incurred earlier in the hotel construction boom.

As the tourist industry lost its momentum, remittances from migrant workers became a major source of foreign exchange receipts. The share of these remittances in total current account receipts increased from two percent in 1980 to 13 percent in 1989. By mid-1985, “exported workers” had become the single most important source of foreign exchange, surpassing earnings from tea exports. Reflecting the changing economic circumstances of the Middle East oil exporters, growth in remittances slackened toward the end of the decade.

Until the early 1970s, the three plantation crops accounted for over 90 percent of total merchandise exports, with tea alone accounting for nearly two-thirds of the total (table 3.20). Since then, gems and garments have also become important sources of foreign exchange. By 1989 the combined share of the “traditional triple” in merchandise exports had declined to 40 percent, while manufactured exports accounted for 46 percent (garments alone accounting for 30 percent).¹⁵

As can be seen in table 3.21, the composition of imports also changed over time, with a distinct shift toward producer goods (investment and intermediate goods). The decline in the share of food imports reflects the expansion of import-substitution production, both in manufacturing and domestic (food-production) agriculture. Sri Lanka’s manufacturing sector is heavily dependent on imported inputs. Out of the total real output of this sector, about 60 percent is directly

Table 3.20 Export Structure, Selected Years, 1974–89
(percent)

<i>Sector</i>	<i>1974</i>	<i>1977</i>	<i>1980</i>	<i>1984</i>	<i>1989</i>
Major agricultural products (tea, rubber and coconut)	71.6	72.8	54.4	57.6	39.4
Minor agricultural products	8.5	7.7	7.2	5.1	4.3
Minerals	3.9	5.0	4.6	2.5	5.6
Manufactured goods (excluding petroleum)	3.6	5.6	14.4	25.5	46.7
textiles and garments	0.8	2.2	10.4	20.5	31.4
Petroleum products ^a	10.1	9.1	17.8	8.9	4.0
Total exports (SDR million)	433	629	812	1,431	1,216

a. Sales of aviation fuel by the state-owned petroleum refinery (import content of which is over 90 percent).

Source: Appendix table A-14 and Central Bank of Ceylon, *Review of the Economy* (annual).

dependent on use of imported inputs (Cuthbertson and Athukorala (1990), table 2.24). The direct import content of gross domestic fixed capital formation varied between 30 and 40 percent over the period 1970–84 (Cuthbertson and Athukorala (1990), table 2.25).

Exchange rate policy played little or no role as an instrument for achieving external balance until the reforms of 1977. A fixed rate with almost no change in par value was maintained until the late 1960s, and even the introduction of a multiple rate in 1968 did not affect the commitment to a fixed rate. Plans to make the value of the FEECs reflect market forces were soon aborted. The switch to a more active policy after 1977 permitted a steady depreciation of the nominal rate in the subsequent period under the managed floating regime, but, as will be discussed later, did not prevent overvaluation of the real rate. The achievement of full convertibility was not seen as a realistic goal within the planning horizon, thus reflect-

Table 3.21 Import Structure, Selected Years, 1950–89
(percentage shares)

<i>Sector</i>	<i>1950</i>	<i>1960</i>	<i>1970</i>	<i>1975</i>	<i>1980</i>	<i>1984</i>	<i>1989</i>
Consumer goods	72.2	61.0	56.0	50.5	29.9	23.2	24.5
food	45.0	38.3	46.3	48.0	18.9	10.4	14.5
Intermediate goods	15.2	20.1	20.0	36.0	47.7	50.0	56.4
Investment goods	12.6	18.1	23.0	12.4	24.0	25.6	17.6

Note: Textile and clothing imports previously classified as consumer goods were classified as intermediate goods in 1989.

Source: Appendix table SA-13 and Central Bank of Ceylon, *Annual Report* (1989).

ing the incomplete nature of the capital market reforms and concern about the consequences of a market-based exchange rate.

Sri Lanka's balance of payments position has been characterized by widening deficits in the merchandise and current accounts, with the exception of small surpluses recorded in 1965 and 1977 (table 3.22). This has been the outcome of adverse movements in the terms of trade and stagnation in export volume, which together reflected a continuing erosion in the import purchasing power of export earnings.

After the boom in tea prices in the mid-1950s, Sri Lanka experienced a sharp long-term deterioration in its commodity terms of trade because of adverse world market conditions (table SA-18). Escalation of import prices, notably after the onset of the first oil crisis, intensified the terms of trade decline. To make matters worse, there were no compensatory movements in export volume. The total export volume index (1978=100) increased from about 80 in the early 1950s to 110 in the mid-1960s, and then fluctuated between 110 and 90 without showing any trend until the late 1980s. In the absence of export volume growth, the index of import purchasing power of export earnings (income terms of trade) moved in tandem with, or declined at a faster rate than, the terms of trade. The slow growth (or stagnation) in export volume, in turn, reflected not so much a failure to develop new export items as stagnation in exports of the traditional export products.

In the 1950s, current account deficits were almost totally financed by foreign reserves accumulated during World War II, the Korean War commodity boom, or the 1954–55 tea boom. After these reserves were depleted, import restrictions became the basic tool for managing the balance of payments up to 1977. However, given persistent adverse movements in the import-purchasing power of export earnings, some reliance on foreign financing was unavoidable.

Sri Lanka's reliance on foreign savings increased to an unprecedented extent after 1977. In addition to the increase in "normal" import flows triggered by liberalization, the rise in external dependence reflected the increased use of foreign finance to implement the public sector investment program. The heavy reliance on foreign finance did not lift the debt service burden to unmanageable levels, since nearly 75 percent of the foreign financial assistance received during this period consisted of grants and long-term loans. The debt service ratio (debt service payments as a ratio of earnings from exports of goods and services), which was 18 percent in 1970–77, declined to 16 percent in 1978–83 but then increased to 24 percent in 1984–89. While such a debt service ratio would have been considered to be a very serious problem in earlier times, this figure was not unduly high by developing-world standards. Nevertheless, the rising debt burden was becoming a matter of concern in the early 1990s.

Table 3.22 Balance of Payments, 1950–89*(SDR millions)*

<i>Year</i>	<i>Exports (FOB)</i>	<i>Imports (CIF)</i>	<i>Trade balance</i>	<i>Current account</i>	<i>Nonmonetary capital^a</i>	<i>Basic balance</i>
1950	296	248	48	28	-6	221
1951	374	324	50	18	-9	9
1952	296	358	-62	-93	6	-87
1953	314	343	-29	-33	-8	-41
1954	362	290	72	64	4	68
1955	397	310	87	67	-10	57
1956	372	331	41	17	-2	15
1957	350	370	-20	-40	-3	-43
1958	341	359	-18	-32	4	-28
1959	372	411	-39	-43	4	-39
1960	377	421	-44	-46	3	-43
1961	358	376	-18	-19	8	-11
1962	370	400	-30	-29	18	-21
1963	358	392	-34	-36	18	-18
1964	371	411	-40	-33	11	-33
1965	401	403	-2	12	3	15
1966	352	423	-71	-60	25	-35
1967	340	417	-77	-60	28	-32
1968	332	395	-63	-69	36	-33
1969	321	446	-125	-133	44	-89
1970	339	391	-52	-58	30	-28
1971	314	361	-47	-36	68	32
1972	284	322	-38	-29	39	10
1973	309	348	-39	-21	57	36
1974	425	583	-158	-113	69	-44
1975	464	632	-168	-91	48	-43
1976	484	557	-73	-5	61	56
1977	651	622	29	117	32	149
1978	675	819	-144	-75	132	57
1979	675	1,037	-362	-117	164	47
1980	818	1,576	-758	-507	306	-201
1981	901	1,596	-695	-381	341	-40
1982	918	1,808	-890	-516	477	-39
1983	993	1,794	-801	-441	420	-21
1984	1,427	1,890	-463	-51	335	284
1985	1,296	2,007	-711	-417	328	-89
1986	1,029	1,678	-649	-363	279	-84
1987	1,077	1,602	-525	-265	234	-31
1988	1,098	1,666	-568	-290	194	-96
1989	1,206	1,748	-542	-290	252	38

a. Direct foreign investment and other private capital (long- and short-term) plus central government loans received.

Source: Central Bank of Ceylon, *Review of the Economy* (annual) and *Annual Report* (annual).

Chapter Four

The First Crisis: 1973–75

In this chapter we focus on the 1973–75 crisis, the policy responses, and the short-run economic impact of crisis management measures. A similar treatment of the second crisis episode is undertaken in the next chapter. Since both episodes involved actual or potential balance of payments crises, our evaluation concentrates on the management of external sector disequilibrium. This chapter begins with an overview of the macroeconomic performance of the Sri Lankan economy during the period 1960–73.

Background to the Crisis

Between 1960 and 1973, Sri Lanka's GDP (at constant 1970 prices) grew at an annual rate of 3.4 percent (table 4.1). Growth was not uniform, however. For instance, throughout the period 1965–69 the annual growth rate was higher than the average figure of 3.2 percent during the period 1960–64. Growth accelerated after 1966 and reached a peak of 7.5 percent in 1968, and then slowed down to 3.5 percent in 1970. In 1971 the growth rate was negative, mainly because of turmoil in the wake of the JVP uprising. In 1972, as the economy recovered, the rate was 2.1 percent. Performance improved considerably in the following year, when an increase of 4.1 percent was recorded.

The lower growth record during 1970–72 is largely attributable to the weak performance of the agricultural sector. The youth uprising had its harshest impact in the rural areas. Moreover, land reform in 1972 disrupted production, and annual crops like rice were particularly affected by bad weather. In addition to these factors, coconut production suffered from an insect pest attack in 1973. Meanwhile, the manufacturing sector, which grew at an annual rate of more than eight percent in the 1960s, recorded slower growth, mainly because of shortages of imported inputs.

Table 4.1 Movement of Major Economic Variables Before and During the 1973–75 Crisis Episode

<i>Economic variable</i>	<i>Annual average 1960–69</i>	<i>1970</i>	<i>1971</i>	<i>1972</i>	<i>1973</i>	<i>1974</i>	<i>1975</i>
<i>Economic growth (annual percent)</i>							
Real GDP	3.9	3.9	-0.8	2.1	4.1	3.3	2.3
Per capita GDP	1.4	1.7	-3.1	0.1	2.1	1.4	0.4
<i>Sectoral growth:</i>							
Plantation agriculture	2.2	1.0	0.9	5.4	-13.3	-2.3	7.5
Agriculture (other)	10.3	5.1	-6.7	-2.1	13.4	19.8	-2.5
Industry	9.8	17.5	1.9	3.3	3.2	-5.2	6.3
Services	4.5	2.4	-0.7	2.9	3.0	5.2	2.9
<i>Employment growth (annual percent)</i>							
Total employment	2.6	3.3	4.0	3.3	-1.7	5.5	2.7
Manufacturing employment ^a	15.6	14.2	8.5	12.5	-14.0	-7.6	4.0
<i>Consumption, saving and investment</i>							
<i>Real per capita consumption (1970=100)</i>							
Real investment (1970=100)	90	100	102	89	89	93	94
Private	80	100	84	82	77	64	70
Public corporations	75	100	90	91	88	69	73
Government	61	100	76	63	49	38	42
Savings/GDP ratio (percent)	105	100	81	81	76	72	86
Private savings	12.2	15.5	15.1	15.7	12.5	8.3	8.1
Investment/GDP ratio (percent)	12.1	16.4	17.0	17.0	11.8	7.2	8.6
Private investment	15.4	17.2	15.2	14.5	13.5	12.5	13.9
Incremental capital/output ratio (percent)	8.5	8.9	9.2	8.6	7.7	8.2	7.9
	3.5	4.3	4.7	4.1	4.9	3.4	3.3
<i>Prices and wages</i>							
<i>General price level (percent change)</i>							
BACCPI	2.6	3.3	4.0	12.9	20.5	25.3	3.7
GDPD	3.5	-0.2	3.5	7.2	15.6	22.9	8.1
<i>Terms of trade</i>							
<i>Agriculture-manufacturing (1970=100)^b</i>							
Plantation sector	95	100	93	89	103	128	98
Domestic agriculture	97	100	91	83	91	108	73
Real wage index (1978=100)	91	100	94	94	112	142	119
Private sector ^c	93	87.2	85.0	80.1	68.4	64.1	71.0
Public sector ^d	157	62.1	62.1	62.3	65.5	73.7	81.5
<i>Real interest rate (annual percent)</i>							
NDB deposit rate	0.5	-2.0	4.0	1.2	1.6	-14.1	-0.2
Commercial bank deposit rate	-2.6	0.7	1.0	0.2	-12.9	-21.5	-0.3
Commercial bank lending rate	-2.9	1.2	1.4	0.4	-8.7	-16.3	0.8

(continued on next page)

Table 4.1 (continued)

<i>Economic variable</i>	<i>Annual average 1960-69</i>	<i>1970</i>	<i>1971</i>	<i>1972</i>	<i>1973</i>	<i>1974</i>	<i>1975</i>
<i>Exchange rates</i>							
<i>Nominal exchange rate (rupees/US dollars)</i>							
Official rate	5.2	6.0	6.4	6.4	6.5	6.6	7.2
<i>Official rate with FEEC premium</i>							
Official rate with FEEC premium	5.9	9.2	9.2	9.9	10.6	10.9	11.6
Curb-market rate	12.6	15.2	18.5	14.4	11.25	12.1	14.8
<i>REER index (1980=100)</i>							
Total exports	55	51	52	48	55	57	54
Traditional exports	72	64	63	61	58	60	57
Nontraditional exports	29	36	41	47	53	54	59
Manufactured goods	27	131	51	51	56	66	74
<i>Trade and balance of payments (SDR millions)</i>							
Trade balance	-47	-52	-47	-38	-39	-158	-168
Current account balance	-48	-58	-36	-29	-21	-113	-91
Basic balance	-30	-28	32	10	36	-44	-43
<i>Foreign reserves in</i>							
import-month equivalent	2.2	1.9	2.5	3.7	3.6	2.2	1.9
Debt-service ratio	7.5	21.7	21.8	21.8	22.9	17.8	22.8
<i>Ratio of outstanding</i>							
debt to foreign reserves	7.1	7.5	3.5	5.2	4.8	5.3	6.8
<i>Trade indices (1978=100)</i>							
Export volume	81	107	104	102	103	89	107
Import volume	112	77	68	67	60	42	53
Terms of trade	144	106	99	94	82	72	58
<i>Import purchasing power</i>							
of export earnings	170	113	102	95	84	64	62
<i>Gross producer margin of export production (percent)</i>							
Tea	16.5	7.2	15.6	18.8	-5.3	5.9	-8.2
Rubber	45.1	31.9	33.5	7.9	37.4	14.6	-9.5
<i>Fiscal operations (percent of GDP)</i>							
Government expenditure	31.6	29.4	30.2	31.5	30.4	27.4	32.5
Government revenue	23.0	20.7	21.5	22.2	22.5	20.5	19.7
Budget deficit	8.6	8.7	9.7	9.2	7.9	6.8	10.5
Expansionary impact ^e	1.5	3.2	1.6	0.8	0.3	0.1	0.8
<i>Real money supply and financial deepening</i>							
M1 (1980=100)	74	84	94	89	87	64	59
M2 (1980=100)	46	63	65	71	61	47	43
M3 (1980=100)	45	62	66	72	64	50	47
M2/GDP	24	22	24	26	22	19	18
M3/GDP	31	29	31	34	30	26	25

a. Employment in organized manufacturing sector.

b. Wages of workers in Wages Board trades.

c. Wages of all central government employees.

d. Ratio between national account deflators for agriculture and manufacturing.

e. Commercial bank borrowings and money creation for the purpose of financing the budget deficit.

Source: Related tables in the text and statistical appendix.

Investment averaged 15.4 percent of GDP during the period 1960–69 and reached 17.2 percent in 1970. It started to fall in 1971 and slumped to 13.5 percent of GDP in 1973 (table 4.1). Land reform, income ceilings, limits on ownership of dwellings, and the Business Undertakings Acquisitions Act, together with the shock of the JVP uprising, created an environment that discouraged private sector investment. Since access to foreign savings also narrowed, investment declined too.

While the available data on employment are fragmentary, estimates suggest a decline in the growth rate of total employment as well as that of employment in the organized manufacturing sector in 1972 and 1973 (table 4.1). According to data from the Consumer Finance Survey of the Central Bank, the unemployment rate increased from 14 percent in 1964 to 24 percent in 1973. Unemployment was particularly acute among educated youth seeking employment in the modern sector (Jones and Selvaratnam 1971 and 1972). As seen in table 3.7, it was the domestic (food-production) agricultural sector that contributed most to labor force absorption between 1963 and 1971. This arrested the decline in agriculture's share of total employment despite considerable labor shedding in the plantation crop sector.

Trade, Balance of Payments, and Budget Deficits

Weakened economic performance in the years leading up to the 1973 shock was the most visible indicator of deeper problems. The protectionist trade regime, the balance of payments situation, and the government's fiscal problems were other markers. These circumstances limited the policy options available to the government when a combination of external and domestic shocks precipitated a crisis in 1973.

Trade Dependence

Policymakers in Sri Lanka, like their counterparts in other developing countries, had expected the growth of domestic production to reduce the heavy dependence of the economy on foreign trade. In particular, it was believed that the domestic economy would be less vulnerable to adverse movements in the terms of trade. As noted in chapter 3, the direct contribution of export agriculture to total domestic output and employment declined from the early 1960s. At the same time, the output and employment shares of domestic manufacturing and agriculture increased significantly. The ratio of imports in final consumer expenditures fell from 32 percent in 1958–60 to 17 percent in 1970–73. These data seem to suggest that the economy had become less exposed to the vagaries of international economic circumstances.

The reality was quite different. The structural transformation expressed in the above figures had been achieved by placing the economy in a new and more precarious posture of trade dependence. The reduced importance of imports in final goods masked greater dependence on imported intermediate and investment goods. This is shown by the data in table 4.2.

Table 4.2 Capacity Utilization of Manufacturing Industry and the Importance of Imported Inputs

Year	Capacity utilization (percent)	Imported inputs as a percent of	
		Total inputs	Gross output
1964–66	—	62	23
1967–69	—	68	25
1970	—	75	28
1971	43	74	26
1972	44	68	32
1973	42	67	32
1974	40	72	40
1975	54	61	40
1976	64	69	40
1977	60	66	40
1978	70	79	49
1979	72	82	53
1980	73	89	59
1981	74	87	57
1982	76	78	50
1983	74	89	35
1984	75	86	30
1985	74	80	28
1986	78	86	—

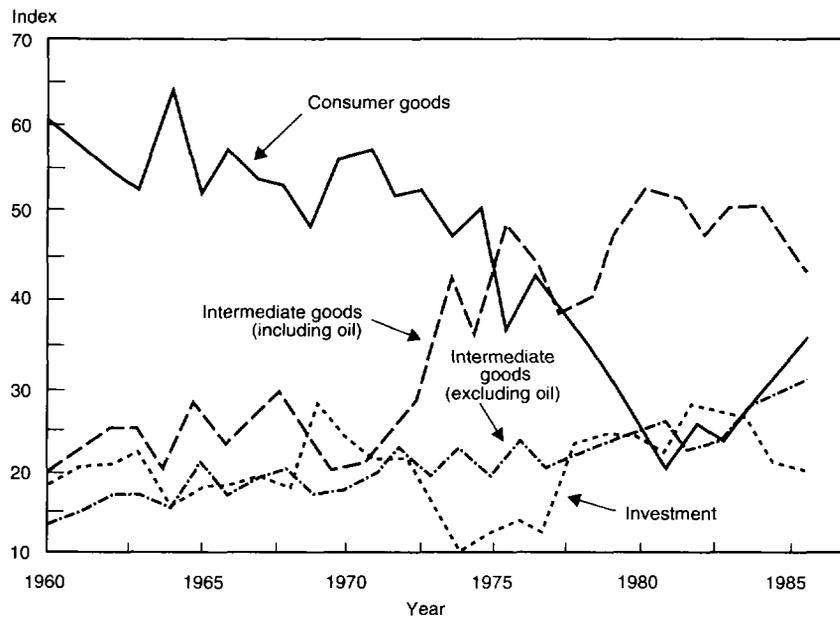
Source: Central Bank of Ceylon, *Annual Report* (1984), and *Review of the Economy* (annual).

Imported inputs used in domestic manufacturing increased from 62 percent of all raw materials imports in 1964–66 to 75 percent by 1970–72. The “direct” import content of gross manufacturing output increased from 23 percent to 30 percent between these two periods. Imported machinery and equipment accounted for over 33 percent of gross domestic capital formation during 1970–73 (Central Bank of Ceylon, *Annual Report—1974*).

Import compression, in short, strengthened import dependence (figure 4.1). The most notable change was a dramatic decline in nonessential consumer goods imports. These accounted for almost one-fifth of total import expenditure in the late 1950s, but by the early 1970s had declined to less than five percent.

On the other hand, as domestic production activities expanded, the demand for intermediate and investment goods grew. The combined share of these imports was 52 percent in 1970–72, compared to 28 percent in 1950–51. The balance consisted mostly of essential food imports. During 1970–72, rice and wheat flour imports alone accounted for 25 percent of the total import bill.¹⁶

Figure 4.1 Sri Lanka - Percentage composition of imports by major use categories, 1960 - 86



Source: table SA-13.

In sum, nonessential imports were gradually converted into the essential imports needed to maintain domestic output and living standards. The upshot was that there was no longer any compressible import fat to cushion unexpected shortages of foreign exchange. By 1973, the import-substitution policy pursued by a highly restrictionist trade regime had made the Sri Lankan economy extremely vulnerable to external shocks.

Surpluses in the Basic Balance via Import Restrictions

At first glance, the balance of payments figures for 1971 and 1972 suggest that problems in the external sector were diminishing. Despite recurring current account deficits, a surplus in the basic balance was achieved in 1971 and maintained in 1972. Moreover, external reserves had risen from their low 1970 level. This picture of relatively benign external sector conditions, however, was misleading.

The improvement in the basic balance was partly due to an increase in external assistance but was primarily the result of stringent import controls. Import volume in 1971-72 was almost 40 percent below the average for the 1960s and had fallen 15 percent since 1970. Export volume had declined marginally from the

1970 level, and by 1972 the import purchasing power of exports had fallen to 84 percent of the 1970 level.

These import restrictions were the response to a mini-payments crisis that had loomed in 1970. The proximate causes were the surge in imports that had followed partial trade liberalization in 1968, unfavorable trends in exports, and the inadequacy of external assistance to deal with the consequent payments gap. The larger incentives given to nontraditional exports did increase their volume but had little impact in the short run. Their volumes during 1970-73 were 20 percent higher than the 1967 level, and their share in total commodity exports was 10 percent, having risen from an average six percent during 1960-66.

The continuing deterioration in the terms of trade and stagnation in overall export volume growth created a payments gap that was financed by increased recourse to suppliers' credits and commercial bank credit, thus raising the external debt level. Such borrowings were necessary because (a) there was no significant private capital inflow; (b) IMF drawings, which had been an important part of external financing, were not available after 1968 (Sri Lanka had fully utilized available concessionary funds); (c) loans from the World Bank were ruled out because of its insistence on cuts in consumer subsidies as a loan condition; and (d) aid flows, though they did rise appreciably during 1965-70, were inadequate to plug the gap. By 1970 the debt service ratio had passed the 20 percent mark and the new UF government, which considered it a dangerously high level, found it hard to obtain further credit (Hewavitharana 1975).

As described in chapter 3, restrictions on nonfood imports were not enough to handle the payments problem. The government was forced to cut back some of its consumer subsidies to stem the pressure on foreign exchange reserves caused by the promise to restore the rice subsidy. The link between the budget deficits, imports, and the balance of payments, which had been a recurrent theme in the Central Bank's annual review of the economy since the 1950s, could not be ignored any longer. But the situation in 1973 was such that little could be done to improve revenues in the short term, while any significant expenditure cuts were bound to be politically difficult or impact adversely on short-run economic activity. Thus, at the time of the first oil shock in 1973, the Sri Lankan economy was already fragile.

The Crisis

The 1973 increase in world oil prices was only one of a series of adverse external and internal shocks. The combined impact of those shocks was such as to make Sri Lanka one of the world's worst-affected economies during this period.

The impact of the oil price increase itself can be seen in table 4.3. Despite a 23 percent reduction in the volume of gross imports, the net import bill increased more than threefold. In addition, fertilizer prices increased as a direct result of the

Table 4.3 Major Imports: Quantity, Price, Volume, and Share in Total Imports

<i>Item</i>	<i>1972</i>	<i>1973</i>	<i>1974</i>	<i>1975</i>	<i>1976</i>
<i>Petroleum products</i>					
Volume-gross imports (millions of barrels)	13.2	12.7	11.0	10.8	10.6
Price (1967/69=100) ^a	147	208	757	826	888
Value-gross imports (millions of dollars)	28	46	136	124	136
Percent of total imports	7.6	10.6	19.0	16.9	23.7
Value-net imports (millions of dollars) ^b	15	26	84	74	77
Percent of total imports	4.2	6.3	12.7	10.9	14.8
<i>Rice</i>					
Volume (thousand tons)	262	338	297	450	419
Price (dollars/ton)	90.7	148.8	403.9	303.7	204.6
Value (millions of dollars)	23.7	50.3	120.0	136.7	85.6
Percent of total imports	6.5	11.2	16.8	18.5	14.6
<i>Flour</i>					
Volume (thousand tons)	324	365	442	455	380
Price (dollars/ton)	111.2	195.8	319.5	319.1	243.1
Value (millions of dollars)	36.3	71.5	141.1	145.2	92.3
Percent of total imports	10.2	16.0	19.8	19.7	15.8
<i>Sugar</i>					
Volume (thousand tons)	214	190	42	61	45
Price (dollars/ton)	194.6	273.6	824.9	619.9	330.2
Value (millions of dollars)	42.5	52.1	34.7	38.0	15.1
Percent of total imports	11.6	11.6	4.9	5.2	2.6
<i>Fertilizer</i>					
Volume (thousand tons)	304	307	358	183	225
Price (1967/69=100) ^c	89	142	465	290	164
Value (millions of dollars)	11	17	33	33	12
Percent of total imports	3.1	3.9	5.4	4.4	2.3
<i>Combined share of above in total import bill^d</i>					
	35.5	49.1	59.2	58.3	37.0

a. Index of world market price of petroleum (World Bank).

b. Value of total (gross) imports minus value of exports by Sri Lanka Petroleum Corporation.

c. Index of world market price of urea (World Bank).

d. Net of export earnings of Sri Lanka petroleum corporation.

Source: Compiled from tables 2.4 through 2.7 in Kappagoda and Paine (1981).

oil price rises, and Sri Lanka's fertilizer import bill doubled. Oil and fertilizer imports rose from just over 10 percent of all imports to more 18 percent.

External shocks did not cease after the oil price rise. In the wake of the oil price increase, there was a worldwide commodity price boom. For many developing countries, these increases in the prices of nonoil commodities helped to cushion the impact of the oil price increase itself. But, given the nature of its imports, this commodity boom exacerbated the adverse impact of the oil price rise on Sri Lanka. The prices of the country's other major imports—rice, wheat, sugar—had started to rise even before the oil price shock. By 1974 the effective import prices of rice and sugar had risen more than four times above 1972 prices, while the price of wheat rose by almost three times. In fact, the rise in the bill for these imported food items exceeded the rise in oil import costs.

Unfortunately, the general price boom affected the prices of Sri Lanka's major exports much less than it did its imports. True, the world price of natural rubber began to rise in 1973, partly in response to the rising costs of petroleum-based feedstocks in the synthetic rubber industry, and tea prices benefited in 1974 from a global shortage of tea due to bad weather in the other main producing countries and a sharp rise in coffee prices in 1976–77. The prices of coconut products also were more favorable, but the cumulative effect of these export price increases was much less than the increase in the import price index. As a result, the terms of trade fell by almost 13 percent in 1973, by 12 percent in 1974, and by a massive 19 percent in 1975. The cumulative impact was a drop of 38 percent from the 1972 level.

The impact of this decline was aggravated by adverse developments on the supply side. Rice production fell in 1973 (table SA-6). It recovered somewhat in 1974 (when output reached the 1970 level) but remained well below the 1970 level through 1977. The beneficial effects of the price rises of Sri Lanka's traditional exports were largely nullified by reductions in output due to management dislocations caused by land reform, bad weather, and (in the case of coconut) insect attacks (Fernando 1980a; Peiris 1978; Thorbecke and Svejnar 1984).

Tea output in 1974, 204 million tons, was the lowest in twenty years. After a slight improvement in 1975 to 214 million tons, output then plunged to 197 tons (the lowest production figure since 1950) in 1976. Rubber output in 1974, 132 million tons, was the lowest since 1960. Coconut output also showed a substantial fall during the period 1972–74 in comparison with any three-year period during the two previous decades (Peiris 1978). The drop in 1973 meant higher domestic prices and led to a two-year ban on exports of coconut oil and copra. As a result of the decline in export volume of the three traditional exports and the drastic fall in the terms of trade, the index of import purchasing power of export earnings fell by nearly 35 percent between 1973–75 (table 4.1). Sri Lanka's share of the total exports of nonoil developing countries dropped to 0.45 percent in 1973–75, compared to two percent in the early 1960s.

The result was a balance of payments crisis. Despite a 30 percent reduction in import volume, the trade deficit quadrupled in 1974 (table 4.1). The current account balance rose from less than one percent of GDP in 1973 to four percent in

1974. According to one study (Jayatissa 1982), the effect of the change in terms of trade worsened the trade deficit by US\$176 million in 1974 and US\$250 million in 1975, while the decline in export volume worsened the deficit by an extra US\$35 million in 1974 and US\$37 million in 1975. Kappagoda and Paine (1981) compared the “possible normal production levels had normal conditions prevailed” with actual production of the three major export crops and estimated that export earnings foregone in 1974 and 1975 were US\$165 million and US\$52 million, respectively. These were approximately equivalent to the current account deficit in 1974 and to about 30 percent of the current account deficit in 1975. The low rice harvests during these years (with the exception of 1974) led to larger rice and wheat imports. Since their prices in the international markets had risen, these imports were a massive additional cost. The rice and wheat import bill, which was US\$60 million in 1972, jumped to US\$222 million annually during 1973–75.

The Policy Response

In theory, the optimal policy response to an unanticipated economic shock depends on whether the shock is perceived as permanent or temporary. A country can attempt to finance an adverse shock believed to be only temporary—that is, if permanent income is not affected. If the shock is deemed to be long-term, however, it represents a cut in permanent income to which it is necessary to adjust. The domestic supply shortfalls clearly fell into the temporary category, since the unusually severe agroclimatic conditions that caused the harvest failures were not likely to persist indefinitely. The duration of the terms of trade deterioration was harder to predict. Throughout the world there was great confusion about the likely duration and intensity of the oil price hike, and this uncertainty affected the perceptions of Sri Lanka’s policymakers.

The dominant view was that external conditions were likely to worsen even more. In other words, the terms of trade decline was seen as permanent. Many in the government, including finance minister N. M. Perera, felt that a global recession (or even a depression) could not be ruled out. Perera, who had lived through the 1930s, was inclined to expect a similar economic collapse in the 1970s. The oil price shock had come soon after the partial breakdown of the Bretton Woods system in 1971 and a resurgence of inflationary pressures in the major industrial economies. In the Budget speech in November 1974, Perera talked of

... the impending disaster that hangs over the world if the perilous course of inflation is allowed to continue unchecked. No country outside the socialist world will go unscathed. The unemployment and frustration, the hunger and disease, and the suffering and degradation that will accompany such a global economic collapse can be better imagined than described.

A successful financing strategy could be pursued only if the government was prepared to make major changes in policy, but there were formidable obstacles to such a course of action. The 1970 election, the increased state control in key sectors of the economy, and the country's foreign policy stance had distanced it from the major Western donor countries. Borrowing under the IMF quota was limited by previous borrowings in 1968-70, while the World Bank had decided in 1971 that "... as long as the new policies were in place it would make no further commitment to Sri Lanka" (Levy 1985:11-12).

Meanwhile, traditional commercial sources had become wary of lending to a government which did not enjoy the confidence of the IMF or the World Bank. By 1971, overseas exporters were refusing to accept letters of credit on Sri Lankan banks unless they were confirmed by foreign international banks, but the international banks were disinclined to provide such confirmation (Hewavitharana 1975).

The government was not especially popular with Western governments either. During the 1970 election campaign the SLFP-led coalition had espoused a great deal of socialist rhetoric to assure their leftist constituencies that the coalition would not adopt pro-capitalist policies. Hence, dealing with international financial institutions like the IMF and the World Bank would expose the government to charges of selling out. Although the support extended to the government by the Western powers during the JVP uprising in 1971 led to some warming of relations, the West was not in-

Table 4.4 Sri Lanka's Account Position at the International Monetary Fund, 1970-75

(SDR millions, end of year)

	1970	1971	1972	1973	1974	1975
Stand-by arrangements:						
Amount drawn	—	14	—	—	7	—
Undrawn balance	—	10	—	—	17	—
SDRs	—	—	13	13	14	11
Percentage of allocation	—	—	38	40	43	32
Use of IMF credits	79	72	75	74	102	125
Compensatory financing	—	—	—	—	—	—
Oil facility	—	—	—	—	34	65
Credit tranche	29	38	37	18	5	4
Extended IMF facility	—	—	—	—	—	—
Quota	98	98	98	98	98	98
Fund's holding of rupees	177	171	173	172	200	223
Percent of quota	180	173	176	176	204	227

Source: International Monetary Fund, *International Financial Statistics Yearbook* (1985).

clined to provide large-scale financial assistance, and aid from the Eastern bloc was quite inadequate to adopt a financing strategy. The government therefore opted to adjust by reducing domestic absorption while attempting to ease the blow through a strategy that relied heavily on direct controls, particularly import restrictions.

External Finance

The 1973 oil price shock softened the attitudes of external lenders. In response to the pleas of the government, there was a substantial rise in aid flows from Western and Eastern bloc nations, and from the multilateral donor agencies. Aid commitments rose from an annual average of US\$110 million in 1970–73 to US\$162 million in 1974, and US\$377 million in 1975; aid disbursements followed a similar pattern. This aid came on somewhat easier terms compared to previous years, though the grant component declined in 1974. Despite the fact that drawings from the IMF tranches were constrained by previous borrowings, the IMF again became an important source of finance (table 4.4). The drawings, however, came largely from the oil facilities program, which had a longer repayment period but a higher interest rate. Discussions in 1975 between Sri Lanka and the IMF on another stand-by agreement broke down, allegedly due to IMF demands for further subsidy reductions (Kappagoda and Paine 1981).

Import Restrictions

The data reported in table 4.5 demonstrate the severity of the import compression policies and their implications for the allocation of imports. In volume terms, im-

Table 4.5 Basic Indicators of Import Compression Before and During the 1973–75 Crisis Episode

<i>Commodity</i>	<i>1960–69</i>	<i>1970–72</i>	<i>1973</i>	<i>1974</i>	<i>1975</i>
Import volume indices (1978=100)					
Consumer goods	82	71	60	42	52
Food	130	122	114	77	83
Intermediate goods	126	133	125	75	87
Investment goods	134	116	64	62	76
Investment goods	63	48	39	23	45
Import composition (percent)	100	100	100	100	100
Consumer goods	56	55	53	47	51
Food	43	46	46	43	48
Intermediate goods	24	24	30	42	36
Oil	7	2	11	20	17
Investment goods	20	21	17	11	13
Import/GDP ratio (percent) ^a	25.2	15.2	13.2	12.4	13.3

a. Estimated using constant (1970) price data.

Source: Relevant tables in the appendix.

ports in 1973-74 were 41 percent below the 1970-72 level, and the 1970-72 figure itself was only 60 percent of the average during the 1960s. Imports had not fallen to such a low level since the 1940s. The sharpest cuts were absorbed by investment goods imports, whose volume fell by 52 percent. The volume of consumer goods fell by 37 percent, and that of intermediate goods 47 percent. The achievement of cuts of this magnitude in such a short time was only possible through the most stringent direct controls, leading to rationing, shortages, and black markets in almost all important commodity markets.

Fiscal Policy

The fiscal response to the crisis was the adoption of orthodox austerity measures, including severe cuts in current expenditures. Government revenues declined in real terms and as a proportion of GDP, mainly because of the reduced volume of trade. Meanwhile, higher import costs reduced the weak profitability of the generally inefficient public sector enterprises. This necessitated large budgetary transfers to these enterprises, though in some cases the higher costs were passed on in part to the public. For example, petroleum prices and transport charges were raised.

The cuts in food subsidies were extensive (chapter 2) and politically painful, but the government felt that they were unavoidable. According to Kappagoda and Paine (1981), the cost of rice imports required to maintain per capita availability of rice at the 1968-71 level would have amounted to an average outlay of 6.1 percent of annual GDP during the 1974-75 period.

To a limited extent, increased imports of relatively cheaper wheat compensated for reduced imports of rice, but in absolute terms wheat too had risen in price. Cuts in the sugar subsidy caused consumption to fall from an annual average of 262,000 tons in 1970-71 to a mere 49,000 tons in 1974-76. The savings produced by reduced imports of sugar alone during the 1974-75 period amounted to US\$294 million, almost equal to the total value of 1974 exports.

Despite the cuts, the government's expenditures on food subsidies actually rose in absolute terms because of higher food prices, though only by a small fraction of the total amount of the price rise. Through such restraint, the government's current expenditures in 1974 were kept below current revenues, and the budget deficit as a proportion of GDP was only 6.8 percent, well below the average for the 1960-73 period (table 4.1).

Current expenditures in 1975 were also kept below current revenues, but the overall budget deficit increased because both food subsidy expenditures and transfers to public sector enterprises rose. Capital expenditures, too, increased somewhat. The deficit was financed by the larger volume of foreign financing that became available in that year and by the savings held in captive funds (the Employees' Provident Fund and the National Savings Bank). Hence, the inflationary impact of fiscal policy was relatively mild.

Monetary Policy

Monetary policy played a subordinate role in the government's response to the crisis. There was no significant attempt to increase interest rates to influence domestic demand for money. In fact, real interest rates in the formal sector were negative in 1974 and (despite some increase in nominal rates in 1975) continued to be very low or negative (table 4.1). There is some reason to believe that *ex ante* rates may have been somewhat higher because inflation was anticipated. Direct controls in the form of ceilings on commercial bank credit for domestic use were introduced in 1974, while selective measures were used to encourage credit for the tradable sectors (exports and import substitutes).

The credit ceilings had no impact, however. Sluggish demand from the private sector made them redundant and left the banks with considerable excess liquidity. A marginal decline occurred in the share of commercial lending for private sector housing and consumption, and there was no noticeable increase in lending for industrial activities.

The real money supply, particularly M1, fell sharply in 1974 (table 4.1) because the fiscal deficit was smaller and was financed mostly by nonexpansionary sources, and because external reserves declined. The reduction of the fiscal deficit would have been even more pronounced had it not been for large borrowings by public enterprises. Public enterprise borrowings were more restrained in 1975.

Exchange Rate Policy

The rupee depreciated substantially in nominal terms during this period because of periodic shifts in favor of the U.S. dollar and British pound in the aftermath of the breakdown of the Bretton Woods system (Hewavitharana 1975). By the end of 1975 the official exchange rate of the rupee had depreciated by about 15 percent relative to the SDR and 18 percent relative to the dollar from their 1970 levels, but this did not reflect a deliberate attempt at using exchange rate policy to respond to external sector disequilibrium. In fact, devaluation of the currency was almost completely absent from public policy discussions during this period. Both the government and the opposition appear to have agreed that devaluation was not an appropriate policy response. While it is known that discussions about the desirability of economic liberalization took place in 1973 in government circles and within the Central Bank (Lal and Rajapatirana 1989), there is no evidence that devaluation figured prominently in those discussions.

Undoubtedly, one reason for not implementing a nominal devaluation was that direct controls had a more immediate impact on the level of imports (Corden 1987). We drew attention earlier to the evidence which suggested that Sri Lanka could not have relied on substantial external funding to meet the looming payments gap, at least without politically difficult changes in domestic policies. Under those circumstances, the resort to direct controls was probably unavoidable.

But it is nevertheless puzzling that a currency devaluation was not seriously considered as part of the overall adjustment strategy.

A part of the explanation for this may have been the widespread view that devaluation of the currency was unlikely to enhance the volume of traditional exports. There had been considerable discussion about the effects of currency devaluations in 1967, when the rupee had been devalued. The opposition at that time was based on the expected impact of devaluation on the cost of living, on the cost of intermediate goods imports, and on pervasive “export pessimism” (see Rasaputram 1972). That is, the low supply elasticities of the major tree crops were considered to make devaluation ineffective as a tool for enhancing exports. The long-term effects of alternative adjustment policies on the tree crop sector received little attention. The establishment of the FECS multiple exchange rate system showed a recognition that a more favorable incentive structure could benefit exports, but this was not extended to the traditional tree crop sector. The same anti-devaluation arguments seem to have influenced the government’s policy stance in 1973–75.

Though the nominal exchange rate depreciated because of exchange rate shifts, there was no significant real devaluation during this period. Indeed, the real rate may have even appreciated slightly (table 4.1). Certainly the rupee was grossly overvalued throughout this period, as attested to by the need for stringent exchange and capital controls, and the high curb (black) market rate. Substantial evasion of exchange rate controls appears to have taken place throughout the period, though accurate quantification is not possible. There is much anecdotal evidence, as well as evidence presented in court when the alleged leader of a currency smuggling organization was brought to trial, that an active and large black market was in operation during the 1960s and early 1970s. According to tentative estimates reported by Fernando and Colombage (1976), the unrecorded outflow of foreign exchange during the 1969–74 period was about 10 percent of total export earnings during that period.

Conservative Attitudes to Inflation

Why did the UF regime decide in favor of an extremely unpopular austerity program rather than adopt an expansionary strategy that might well have been politically less costly, at least in the short run? True, a conservative attitude to inflation had been inherited from the period of British rule and the Currency Board System. Moreover, the Monetary Act of 1950 had anti-inflationary principles built into it and required the Central Bank to act if, in a given month, the rate of inflation exceeded 10 percent or the growth of the money supply (M1) exceeded 15 percent of the rate for the corresponding month in the previous year (Gunasekara 1962).

But the political pressures that came to bear on the government, particularly on the left-wing parties in the coalition, were unprecedented. Moreover, the left-wing parties exerted substantial influence on financial policymaking, particularly in the early years of the SF government. In the circumstances, it would not have

been surprising if the left had pushed for a more expansionary policy. But leaders on the left, including finance minister Perera, were as strongly opposed to an inflationary strategy as the technocrats of the Central Bank and the conservative politicians of the right. In fact, the left resisted pressure from SLFP back-benchers to reject austerity.

The anti-inflation attitudes of the left reflected the views of their trade union constituency, whose real wages would have been rapidly eroded by inflation. In addition, they may have been influenced by their experience with inflation in Europe during the interwar years. Most of the leftist leaders had spent their politically formative years in Europe during the late 1920s and 1930s, and saw a link between hyperinflation and the rise of fascism.

The Pattern of Adjustment

It could be argued that the effects on growth of the crisis management policies adopted during the 1973–75 period should be compared with trend rates of growth of the relevant variables in the immediately preceding period. However, there are problems in adopting this approach, since the years 1971 and 1972 were abnormal in many ways. The political disturbances of 1971 severely disrupted economic activity, and real GDP fell. Although the economy began to recover in 1972, recovery to more normal levels did not take place until 1973. The 1970–72 period was abnormal in other ways as well. The economy was subjected to severe import and exchange controls, and land reform affected output in the plantation crop sector along with drought and pest attacks. Thus, the 1960–69 period is a better reference period for evaluating performance during 1973–75.

Adjustment to the shocks of the early 1970s included major reductions in both consumption and investment. Private consumption had already fallen substantially in 1972 because of the political disturbances of 1971 and remained depressed until 1975 (table 4.1). The reduction in private consumption was accompanied by a large reduction in government consumption. Even in 1975, when private consumption began to recover, the continued squeeze on public consumption dampened the recovery. It took more than a decade for government consumption to reach its pre-1973 level in per capita terms.

Data on per capita food consumption indicate that food intake declined during this period. Per capita staple food availability declined from an average of 441 pounds of rice equivalents to 394 pounds between 1971 and 1974 (Gavan and Chandrasekara 1979). Real wages also declined markedly (table 4.1). To some extent, private consumption expenditures were sustained because consumers were willing to reduce their savings. Private savings during 1973–75 declined to nine percent of GDP, compared with 16 percent during 1970–72 and 12.2 percent during 1960–69. Such behavior is consistent with the possibility that private agents

considered the effects of the shocks to be largely transient, with little effect on their permanent income.¹⁷

This reduction of private savings was reflected in the slowdown in the growth rate of private financial savings held in the form of time and savings deposits in financial institutions (table 4.6). Time and savings deposits had grown rapidly during 1970–72, stimulated by the expansion of the banking infrastructure, the demonetization of higher denomination currency deposits in 1970, and the raising of savings deposit interest rates. In 1973 the amount of private savings held in financial institutions slumped sharply in real terms, and then grew sluggishly in 1974 and 1975.

There was also a dramatic fall in investment. Private sector investment fell in both absolute and relative terms. During the 1973–75 crisis period, the generally unfavorable situation was aggravated by the import control policy that gave first priority in import allocation to public sector enterprises, particularly those producing domestic intermediate goods. Analyses of this period have tended to portray this policy in a favorable light (see, for example, Kappagoda and Paine 1981). It should be noted, however, that many of these public sector enterprises were highly inefficient (Sirisena 1975; Wanigatunga 1974). Channelling intermediate goods through these enterprises raised costs to user industries downstream. Therefore it is probable that this method of producing intermediate goods imposed an additional burden on the economy. Similar comments apply to at least that part of the public sector investment which took the form of capital grants to state enterprises.

Inflation and Real Wages

Sri Lanka had very low inflation until the 1970s. The crisis years then witnessed a surge in inflation, according to all available price indexes. The GDPD showed the

Table 4.6 Growth of Time and Savings Deposits, 1966–77

(annual percentage change)

<i>Year</i>	<i>Nominal</i>	<i>Real</i>
1966–69	10.1	12.5
1970	17.3	15.0
1971	14.5	11.0
1972	14.4	10.1
1973	3.6	-13.8
1974	19.8	6.2
1975	9.7	2.4
1976	23.8	17.8
1977	41.8	23.1

Note: Real values are computed using the GDP deflator.

Source: Central Bank of Ceylon, *Annual Report* (annual).

rate of inflation rising from 7 percent in 1972 to 16 percent in 1973 and 23 percent in 1974. In terms of the Bhalla-adjusted CCPI, the increase in prices was much higher, with the price level in 1974 being more than 75 percent above the 1972 level. Supplside factors were primarily responsible for this increase.

Upward adjustment of the prices of consumer goods, the rationing of many commodities, and domestic supply shortfalls (mainly, the decline in paddy production) contributed to these price rises. Meanwhile, the restrictive stance of fiscal policy, the generally tight monetary policy, and the effects of declining external assets tended to dampen money supply growth. Because of the strong link between money supply and prices in Sri Lanka (Ranaweera 1978; Athukorala and Huynh 1987; Jayamaha and Wilson 1989), inflationary pressure was contained by the nonaccommodating monetary policy. By 1975 inflation was under control.

Real wages in all sectors declined considerably during this period without much resistance from the trade unions. The reductions in current real wages understated the cuts in the real incomes of trade union members, due to one government action that received little attention at the time or subsequently. This was the use of employees' savings held in the Employees' Provident Fund to finance budget deficits. As the interest rates on these funds were artificially repressed, and as real interest rates were generally negative, this represented a tax on the future incomes of employees, the bulk of whom were members of the trade unions. Trade union reaction to inflation during the period was strongly influenced by the link to the left-wing parties in the government. The leadership ensured that the unions did not express open opposition despite rising inflation and reduced subsidies. Thus the policy package could be pursued without major industrial conflict, which would have been unthinkable if any other government had been in power.

National and Sectoral Growth

Real GDP grew by 3.3 percent in 1974, 2.3 percent in 1975, and 3.3 percent in 1976 (table 4.1). Comparison with the 1960–69 period makes it clear that growth slowed down substantially, even though the economy did not contract in absolute terms. The average real GDP growth rate during 1973–75 was 2.7 percent, as against 4.0 percent during 1965–9.

Real agricultural output during 1973–75 was only marginally higher than in 1965–69. This was mostly due to the poor performance of the three major export crops (table 4.1), and that of paddy in 1972 and 1975. At least part of the decline in output of plantation crops can be attributed to declining investment in replantings and to greatly reduced fertilizer use. Fertilizer imports during the 1971–74 period averaged 312,000 tons per year. They fell to 183,000 tons in 1975, and continued to fall during the next two years. An even worse sectorwide performance was avoided thanks to an expansion in the subsidiary food sector, which responded to the higher prices produced by import bans. The import restrictions, reductions in food subsidies, and higher food prices tilted the sectoral terms of trade in favor of domestic food-production agriculture (table 4.1) and stimulated the culti-

vation of subsidiary food crops. Again, in any assessment of this growth, the efficiency costs of the distorted incentive structure must be recognized. The pattern of growth in this sector would have been considerably different in the absence of high effective protection.

The import restrictions hurt the manufacturing sector as a whole because of its very high import dependence. The growth rate of manufacturing sector output slowed down in 1971 and turned negative in 1974. This slowdown was most severe in private sector manufacturing ventures. Overall capacity utilization levels remained quite low (table 4.2), and total manufacturing employment fell sharply in 1973 and 1974 (table 4.1).

Reflecting the impact of increased selective incentives, nontraditional exports (notably gems and manufactured goods), showed a significant improvement from about 1970 and this trend continued during the period 1973-75. Recorded gem exports grew from about SDR 0.7 million in 1970 to SDR 21 million in 1975 (table SA-14). Manufactured exports during the same period grew from SDR four million to SDR 33 million. The combined share of nontraditional exports (excluding petroleum) in total nonpetroleum commodity exports increased from 10 percent to 17 percent between 1970 and 1975. However, given the low starting base, exports remained small in absolute terms, and the expansion of these exports had only a marginal cushioning effect against the unsatisfactory performance of traditional exports.

In general, however, the steps taken to achieve structural changes in the economy fell well short of what would have been necessary, particularly in view of an assessment of the terms of trade shock as a permanent one. The measures adopted to stimulate the tradables sectors were basically higher (and selective) incentives for nontraditional exports. Nothing in the adjustment strategy suggested that fundamental changes in the economy were likely.

Recovery from the First Crisis

Sri Lanka's external payments position had begun to improve by the end of 1975. The government's prompt response to the 1973-75 crisis by way of reductions in expenditures and realignment of priorities certainly played a role, but favorable external changes also helped. In 1976 the trade balance improved because the terms of trade became better thanks to a reduction in import prices and higher prices for exports. But the economy was slow to respond. The traumatic stresses of the 1973-75 period had sapped its vitality.

In 1976 the government eased its deflationary fiscal stance, which was now attributed solely to Perera, who had been compelled to leave the government in 1975. A more expansionary budget was financed with a substantial increase in borrowing from the Central Bank. As a result, M1 rose by 34 percent, the highest rate of annual increase until then. Time and savings deposits rose by nearly 24 percent, helping to moderate the impact of the rise in M1.

Unlike many developing countries, Sri Lanka emerged from the 1973–75 period with only a small external debt. But the UF government was to pay a heavy price for the deflationary approach. The import restrictions and the cuts in consumer subsidies were extremely unpopular. The government was thus unable to take advantage of the improvement brought about by the terms of trade changes. The import controls inhibited the effective use of rising external reserves to ameliorate the consumer goods shortages and win back some of the lost popular support before the election in 1977. The groundswell of unhappiness with the government paved the way for the UNP to come to power again.

Chapter Five

The Second Crisis: 1978–82

Two shocks struck the Sri Lankan economy in the 1978–82 period, the first domestic and the second external. The first was an enormous upsurge in investment, particularly public sector investment. We will call this the public sector investment program (PSIP) shock. The PSIP shock was the result of a deliberate decision by the newly elected UNP government. The financing of this investment entailed a massive capital inflow, since domestic savings were an utterly inadequate source of funds. In addition to the capital flows directly related to the PSIP, a large increase in private inflow also took place. Inevitably, the inflows led to a big current account deficit and a real appreciation. The second shock was a dramatic deterioration of the terms of trade. The world price of tea fell, while import prices, including those of oil, fertilizer, and sugar, again rose strongly.

The Background of the Crisis

When the UNP government was elected in 1977 it inherited a considerably more favorable external payments situation than that which faced the UF government in 1970. By 1977 the world economy had recovered from the first oil price shock, and this was reflected in Sri Lanka's terms of trade. In addition to the general improvement of the international economy, the country benefited from a sharp improvement in tea prices that began in 1976. There was also a significant decline in import prices. Consequently, in 1977 Sri Lanka experienced its most favorable terms of trade since 1970, and (despite stagnation in export volume) the index of the import purchasing power of export earnings showed a 22 percent improvement over the 1976 level (table 5.1).

These positive developments were not confined to the trade account. There had also been a small but significant improvement in the services account, owing to rising migrant-worker remittances and receipts from tourism. In 1977 these two

Table 5.1 Movement of Major Economic Variables Before and During the 1978–82 Crisis Episode

<i>Economic variable</i>	1976	1977	1978	1979	1980	1981	1982
<i>Economic growth (annual percent)</i>							
Real GDP	2.9	4.6	8.2	6.5	5.5	6.1	4.8
Per capita GDP	1.3	3.0	6.4	4.6	3.6	5.0	2.8
<i>Sectoral growth</i>							
Plantation agriculture	-8.6	-0.8	4.1	4.1	-10.0	7.5	-1.5
Agriculture (other)	9.5	23.9	5.4	7.3	6.3	2.8	3.5
Industry	9.5	23.9	13.5	8.4	4.0	3.5	3.4
Manufacturing	5.7	1.5	10.8	4.8	6.1	4.2	9.1
Services	1.0	4.7	7.6	7.8	8.0	6.4	7.0
<i>Employment growth (annual percent)</i>							
Total employment	1.2	1.5	3.5	4.0	—	—	—
Manufacturing ^a employment ^a	4.0	5.7	14.8	7.4	5.6	6.4	3.7
<i>Consumption, Saving and Investment</i>							
<i>Real per capita consumption</i>							
(1970=100)	94	96	103	105	103	104	110
<i>Real investment</i>							
(1970=100)	84	64	116	160	217	218	272
Private	77	60	82	146	160	179	229
Public corporations	56	57	145	167	413	411	514
Government	124	82	165	192	205	192	182
<i>Savings/GDP ratio</i>							
(percent)	13.9	18.1	15.2	13.7	11.2	11.7	11.8
Private savings	14.2	17.8	16.5	13.3	14.8	13.4	13.3
<i>Investment/GDP ratio</i>							
(percent)	15.4	13.8	19.9	25.2	31.2	27.3	31.9
Private investment	8.7	7.2	8.9	13.1	13.7	13.0	14.7
<i>Incremental capital/ output ratio</i>							
	3.5	4.2	2.0	3.1	4.4	5.8	5.4
<i>Prices and wages</i>							
<i>General price level (percent change)</i>							
BACCPi	5.6	9.2	9.7	16.1	23.4	19.5	8.1
GDPD	6.3	20.2	7.6	8.3	21.1	16.0	17.1
WPI	8.6	20.9	15.5	9.5	33.7	17.0	5.5
CBCPI	3.8	15.0	8.9	18.6	37.1	23.8	11.1
<i>Terms of trade</i>							
<i>Agriculture-manufacturing</i>							
(1970=100) ^b	112	107	118	95	103	98	86
Plantation sector	100	127	136	127	131	126	117
Domestic agriculture	120	96	108	76	90	85	77
<i>Real wage index (1978=100)</i>							
Private sector ^c	69	77	100	100	94	98	83
Public sector ^d	105	97	100	98	82	75	88
<i>Real interest rate (annual percent)</i>							
NDB deposit rate	-8.4	8.1	2.3	-5.1	2.3	0.3	-5.1
Commercial bank deposit rate	-11.1	7.7	1.1	-5.3	2.9	1.0	-9.3

(continued on next page)

Table 5.1 (continued)

<i>Economic variable</i>	1976	1977	1978	1979	1980	1981	1982
Commercial bank lending rate	-7.1	8.4	1.5	-3.2	2.6	1.6	-2.9
<i>Exchange rates</i>							
Nominal exchange rate (rupees/US dollars)							
Official rate	8.4	8.9	15.6	15.6	16.5	20.8	23.5
Official rate with FEEC premium ^c	14.5	14.81	—	—	—	—	—
Curb-market rate	13.8	17.8	21.3	21.8	19.6	21.8	23.5
<i>REER index (1980=100)</i>							
Total exports	64	76	90	88	100	98	89
Traditional export	68	78	94	91	100	95	86
Nontraditional exports	62	81	80	84	100	101	81
<i>Trade and balance of payments (SDR millions)</i>							
Trade balance	-73	29	-144	-362	-758	-695	-890
Current account balance	-5	117	-75	-117	-507	-381	-516
Basic balance	-56	149	57	47	-201	-40	-39
Foreign reserves in							
import-month equivalent	3.1	10.6	5.9	5.1	2.4	3.1	3.3
Debt-service ratio	20.6	15.9	5.5	12.9	12.9	16.8	18.6
Ratio of outstanding debt to foreign reserves							
	4.5	2.4	2.3	2.0	4.5	4.9	5.0
Trade indices (1978=100)							
Export volume	102	94	100	101	99	102	112
Import volume	52	73	100	123	140	145	150
Terms of trade	80	96	100	72	58	46	38
Import purchasing power of export earnings	78	102	100	72	58	46	38
Gross producer margin of export production (percent)							
Tea	2.4	60.5	-2.1	-17.1	3.2	-5.4	2.5
Rubber	32.3	20.6	42.7	34.6	29.5	11.9	5.3
<i>Fiscal operation (percent of GDP)</i>							
Government expenditure	33.2	28.1	46.5	43.2	48.7	39.1	41.3
Government revenue	20.4	19.2	28.8	25.5	22.6	20.4	19.4
Budget deficit	12.7	8.8	17.7	17.6	26.1	18.7	21.0
Expansionary impact ^f	2.3	-2.3	0.4	1.2	10.3	4.6	5.8
<i>Real money supply and financial deepening</i>							
M1 (1980=100)	58	69	82	94	100	96	107
M2 (1980=100)	44	54	71	87	100	109	131
M3 (1980=100)	49	55	73	89	100	108	133
M2/GDP	18	24	26	29	30	31	31
M3/GDP	25	32	34	38	38	40	40

a. Employment in organized manufacturing sector.

b. Wages of workers in Wages Board trades.

c. Wages of all central government employees.

d. Ratio between national account deflators for agriculture and manufacturing.

e. FEEC system was abolished in November 1977.

f. Commercial bank borrowings and money creation for the purpose of financing the budget deficit.

Source: Related tables in the text and appendix.

items contributed about 11 percent of current account receipts, as against three percent in 1975. Overall, the current account deficit had declined from SDR 102 million in 1975 to SDR six million in 1976. In 1977 there was a current account surplus for the first time since 1965. Reflecting the improved current account position and the inflow of concessionary foreign capital in support of the market-oriented policy stance of the new government, foreign reserves increased from an average level of three months of import equivalents during 1970–76 to eleven months by the end of 1977. This was the largest figure recorded in a single year since 1951.

By 1975 there had been no significant improvement in economic growth, even though the worst of the crisis was past. This probably increased unemployment considerably, particularly in urban areas, but accurate assessment is not possible. The 1973 Labor Force Survey of the Central Bank estimated unemployment at about 17.6 percent of the total labor force. A 1977 urban budget survey conducted by the Census Department found an unemployment rate of 27.8 percent for the survey area and 29.4 percent for Colombo (table 3.7). Inflation had come down since the 1973–75 period. Although the acute shortages of that period had been alleviated, repressed demand for imports was certainly present for both consumer and investment goods. The implementation of the liberalization program was also the signal for the beginning of the investment surge.

The Investment Boom and the Terms of Trade Decline

The magnitude of the investment drive initiated in 1978 was striking. During the previous decade, total investment had been on average 15 percent of GDP (table 4.1). This figure began to rise so rapidly that by 1980 it exceeded 31 percent (table 5.1). This rise was primarily due to the PSIP, which raised the ratio of public capital expenditure to GDP from an average of about 6.5 percent in the period 1970–77 to about 18.5 percent by 1980.¹⁸

The most striking feature of the PSIP was the heavy emphasis placed on the Accelerated Mahaweli Development Project. During the period 1979–85, almost one-third of all government expenditure was devoted to the project (table 5.2), which also absorbed nearly 45 percent of the project funding committed by donors during this period. The second largest project of the program was a housing-cum-urban-development scheme (including the building of a new capital and a monumental parliament house), which accounted for about 10 percent of public investment allocation in 1979–85. Thus, close to half of all public investment was channeled into only two projects.

Work on the Mahaweli Project (see chapter 2) began in 1970, and the first trans-basin division was completed in 1976. The new UNP government announced its intention to accelerate the pace of the project in November 1977, four months after its accession to power. The new regime wanted to complete the entire project

Table 5.2 Allocations for the Accelerated Mahaweli Development Project, 1979–86

<i>Source</i>	1979	1980	1981	1982	1983	1984	1985	1986
Millions of rupees	1,603	2,991	3,991	5,469	7,302	7,195	5,541	34,092
As a percentage of:								
Total government expenditure	8	10	14	15	17	14	8	13
Government capital expenditure	21	25	34	34	44	37	23	32
GDP	1	4	4	6	6	4	3	9
Aid-funded share percent of total investment	30	48	45	61	56	65	83	78

Source: Compiled from Government of Sri Lanka, Ministry of Finance and Planning, *Public Investment* (annual).

in six years, as against the original 30-year completion target, at an estimated cost of 11,000 million rupees (US\$610 million).

Yet past experience, both in Sri Lanka and elsewhere, gave ample reasons for doubting the project's technical feasibility as well as its economic benefits (Iriyagolle 1978). In fact, an interim implementation report prepared in 1978 by a group of Dutch consultants recommended a slower rate of construction (Karunatilake 1987). The report argued that any attempt to implement such a large project in such a short period of time was likely to place unmanageable strains on Sri Lanka's institutions and resources. The consultants' final report, released in 1979 and assuming considerable increases in the prices of oil and rice, predicted a rate of return of 11 percent for the entire project. That was not a very impressive figure, given the alternative investment opportunities offered by an economy whose capital stock had been deteriorating for a long period. Although the economic rationale for the project was weak, and the consultants themselves had expressed reservations about its value, the government decided to press ahead.

The government's decision, which appeared to one analyst to be "nothing more than a substantial gamble" (Stern 1984), was based on the following rationale. First, the government saw the project as an effective means of harnessing concessionary foreign funds. President Jayawardene felt quite sure that foreign aid could only be obtained for a relatively short period of time, and that the opportunity to lock up funding for large, long-term projects had to be grasped (Jayawardene 1979). Moreover, few project proposals other than the Mahaweli were ready to be presented to donors. In addition, the government wanted to cultivate a project that would capture the imagination of the people and thus persuade them to endure some economic hardship for the sake of future prosperity. The government's planned reduction of consumer subsidies and its substantial dismantling of import restrictions (which resulted in labor-shedding in such domestic industries as hand-loom textiles) were bound to arouse popular dissatisfaction. Hence, the vision of a mammoth irrigation scheme designed to achieve rice self-sufficiency

and thus rekindle the glories of ancient Sinhalese civilization was enormously appealing to populist politicians (Levy 1985). As Stern (1984:27) pointed out, “no other development program could have appealed to the electorate in the same way as the Mahaweli program.” Finally, and very importantly, a large public sector infrastructure-cum-settlement project offered a mechanism for political patronage by enabling the government to provide employment on a large scale to youth and a promise of land to the rural poor. In short, economic considerations were pushed aside by political objectives.

Yet donor response to the idea of accelerating the Mahaweli project was swift and positive. In many cases the donors announced their commitment well before the completion of feasibility studies and estimation of project costs (World Bank 1980). Before 1978 had ended the main donors had committed themselves to funding the three major upstream dams that were to be the cornerstones of the scheme. Moreover, the donors responded favorably to a suggestion by the World Bank that commitment to the project should be considered in addition to the amount of aid that would be forthcoming for Sri Lanka in the absence of the project. The World Bank itself became a major sponsor of the project.¹⁹

The enthusiasm of the donors for the Mahaweli scheme spilled over to other projects as well, and total foreign commitments to Sri Lankan development projects increased from US\$175 million for the entire 1970–77 period to US\$390 million for the three years 1978–80.

By 1980, however, it was clear that the investment program was generating strains in the economy. The estimated cost had shot up to about 18,000 million rupees (US\$860 million) as a result of the project’s acceleration and subsequent cost overruns.

The most direct impact was on the fiscal deficit. Although a major share of the program costs was being funded by the donors, the local funds required for implementation were substantial (table 5.2), and curtailment of these local funds became virtually impossible once the program was set in motion. The government was forced to supplement the foreign funding with domestic borrowing to finance its large budget deficits. Subsequently, the government also resorted to foreign commercial borrowing.

The donors’ contribution was mostly intended to pay for the costs of imports needed for the project. However, they also paid a share of the project’s domestic costs, producing a significant net inflow. This, together with remittances from migrant workers, created upward pressure on the foreign exchange rate. When the terms of trade shock occurred in 1979, the economy was already showing the strains imposed by the government’s rush to implement its massive investment program.

The Terms of Trade Shock

The terms of trade decline started in late 1978 and gathered momentum in 1979, when it fell by 28.3 percent. This was followed by falls of 18.4 percent in 1980,

22.6 percent in 1981, and 16.7 percent in 1982. The cumulative decline between 1978 and 1982 was 62.3 percent (table 5.1). Overall, Sri Lanka was one of the developing countries hit hardest by the second oil price hike and the associated world recession. Balassa and McCarthy (1984) estimated that the total negative effect of exogenous shocks on Sri Lanka was equivalent to a drop of 25 percent of GDP during the 1979–81 period, compared with an average of five percent for developing countries as a group.

Total earnings (SDR 3,400 million) from commodity exports during the 1979–82 period were almost 50 percent higher than for the preceding four years. However, the escalation of import prices more than counterbalanced this increase. Consequently, the index of capacity to import (income terms of trade) declined by almost 30 percent between the two periods.

The impact of the terms of trade change was aggravated by poor performance in the plantation crop sector. Despite much rhetoric, little was done to improve the management of state-owned plantations, and the decline in production levels that had started in the early 1970s continued. Average tea production during 1980–82 was similar to the 1959–61 average (table SA-6). Rubber production in 1982 (125 million tons) was the lowest in twenty years. Coconut production and exports showed some improvement during 1978–82, but this improvement was minuscule compared with the production loss in tea and rubber.

Export earnings were also affected by the declines in export volume. In 1979, for instance, the decline in the world price of tea was accompanied by a decline of 3 percent in the volume of tea exports. Despite a five percent reduction in crude oil imports, the bill for imported oil rose very sharply. By the end of 1979, the balance of trade showed a 23 percent rise in imports and stagnant aggregate exports. As a result, the trade deficit in 1979 rose by 150 percent over the 1978 figure. Jayatissa (1982) estimated that 80 percent of the negative effect on the trade balance came from changes in the terms of trade and 20 percent from decline in export volume.

This deficit in the trade balance did not, however, place strains on the overall balance of payments in 1978 and 1979. The country had to run a deficit in the current account to absorb the inflow in foreign capital, and a larger trade deficit was a reflection of this absorptive process. About 20 percent of the imports were financed directly by foreign unrequited net transfers. Capital inflows (aid, concessional loans, migrant-worker remittances) increased so substantially that the balance of payments actually showed a surplus of SDR 35 million (table 5.1).

The trade deficit of SDR 758 million in 1980 was a record, and double the amount of the previous year. Despite significant increases in the surpluses of services and transfers, due mainly to remittances, the current account deficit nearly tripled to SDR 507 million in 1980. External reserves had to be used to finance the current account deficit, since the capital flows were insufficient, and Sri Lanka experienced a serious decline in external reserves for the first time since 1975 (Central Bank of Ceylon *Annual Report—1980*).

Policy Response

The terms of trade decline had no immediate influence on policymaking. The optimism that characterized policy discussions in the 1978–79 period was barely affected by it. For instance, the Central Bank of Ceylon *Annual Report—1979*:171 pointed out that:

... the high levels of trade deficit and the resultant current account deficits are also a reflection of the fact that the country has been utilizing the aid receipts, which otherwise would add to external assets. In the circumstances, the more useful indicator of the balance of payments position of the country would be the overall balance which reflects the net change in external assets.

The rationale for this view rested in part on expectations of a J-curve adjustment—that is, the initial deterioration in the current account due to high levels of investment goods imports would be followed by current account surpluses once the investments generated higher exports. The devaluation of 1977 and the longer-term effects of trade liberalization, together with the future output from current investments, were expected to generate a future expansion of tradables production that would be sufficient to meet financial obligations.

The belief that resource constraints no longer mattered had become pervasive in Sri Lanka. For instance, the budget speech in November 1979, while noting the world recession and its adverse effects on Sri Lanka, outlined ambitious goals for 1980. There was no sign of a realization that Sri Lanka was in the first stage of its most dramatic terms of trade shock in decades. GDP growth rates of 8.2 percent in 1978 and 6.3 percent in 1979, and a seemingly never-ending flow of external resources, created an environment in which little attention was paid to the negative developments occurring in the larger world.²⁰ The huge foreign aid flows encouraged many within the government to engage in lavish expenditures; ministries were able to obtain additional funds whenever they requested them, even though the finance minister had begun to complain about a deterioration in financial discipline within the government.

Impact on the Fiscal Deficit

As a share of GDP, government expenditures increased to 49 percent in 1980 from 43 percent in 1979 (table 5.1). This increase was mainly attributable to the massive increase in capital expenditures, which rose from 11 percent of GDP to 22 percent. Revenues, on the other hand, declined from 25.5 percent to 22.6 percent of GDP. In other words, the substantial surplus in the current account of the budget generated through cuts in food subsidies disappeared.

In part, revenues declined because of lower receipts from export duties. Immediately after the currency reforms the government had moved to siphon off a large part of the gains to exporters via progressive export taxes, but it soon became

clear that the tax burden on traditional exporters was destroying their viability. In 1979 there was a reduction in the export duty on bulk tea to assist the ailing tea industry. Export tax revenues on coconut declined sharply due to supply shortfalls and consequent lower exports. While tax revenues from rubber exports increased marginally, lower export volume reduced the potential gains. Overall revenues from export duties declined by 13 percent in current terms. On the other hand, import duty receipts increased substantially, so that the net effect was marginally higher revenues.

Sri Lanka's fiscal deficit in 1980 was an unprecedented 26 percent of GDP. Foreign assistance funded a large proportion of the deficit, and the government was also able to engage in substantial noninflationary domestic borrowing, particularly from "captive funds." These, however, were inadequate to finance this deficit fully, and the government was compelled to borrow heavily from the Central Bank.

This, not surprisingly, stimulated inflation, which rose to a historic high of 26 percent as measured by the Colombo CPI. Other indices indicated that the inflation rate might have exceeded 30 percent. In addition to the expansionary effect of the public investment program, rising international prices also had a larger impact on the domestic price level due to the increased size of the traded goods sector and more open economic policies. The impact of world price rises was magnified by the sharp depreciation of the nominal exchange rate, whose value declined by 10.8 percent against the SDR during 1980. Another contributory factor was the reduction of consumer subsidies, leading to higher prices and subsequently to pressure to raise real wages (Stern 1984).

Three factors helped to prevent inflation from rising even higher. First, the decline in external reserves brought about by the terms of trade shock tended to reduce the money supply. Second, high nominal interest rates had produced a very large buildup of time and savings deposits which provided noninflationary sources for public borrowing (table 5.1). These deposits constituted nearly 70 percent of M3 in 1982 and were equivalent to 5.9 percent of GDP that year, compared to 2.1 percent in 1981. Third, greater openness to imports helped to curtail increases in prices.

It was only two years after the terms of trade deterioration began in late 1978 that measures were taken to adjust to external problems. These included a combination of monetary and fiscal policy measures. The first response to the crisis came from the Central Bank in April 1980, and occurred chiefly because of concern about the rise in the inflation rate. The Central Bank raised the bank rate from 10 percent to 12 percent per year.²¹ As a further move to discourage commercial banks from resorting to Central Bank credit, the penalty rate was raised from a range of 15 to 25 percent to a range of 20 to 30 percent. Following these increases, the Treasury bill rate rose from 9 to 13 percent per year, and the rate on government securities went from 10 percent to 16 percent per year. The rates of interest on deposits at the National Savings Bank and at commercial banks were also raised, as were the lending rates of commercial banks and other lending institutions (table 3.9).

These measures were quite effective in stemming the rapid growth of the money supply. The annual growth rate of M1 dropped from 25 percent in April 1980 to 15 percent in September 1980. Commercial bank borrowing from the Central Bank fell by half. As a result, the interbank call money market rate rose from 12 percent earlier in 1980 to a peak of 25 percent toward the end of the year (Central Bank 1980). However, the slowdown in the growth of the money supply was short-lived as government borrowing again produced a sharp rise in the money supply toward the end of the year (table 5.1).

When strong inflationary tendencies emerged in the first quarter of 1981 in association with rapid growth in the money supply and domestic credit demand, the Central Bank intervened directly. In May 1981 the Central Bank imposed credit ceilings on the commercial banks. The ceilings were removed in June, but other measures to restrain commercial bank credit were taken, such as raising the bank rate. In August 1981 the bank rate was raised to 14 percent, while the penalty rates were raised to a range of 21 to 35 percent. These measures were quite successful in reducing excess liquidity. By the end of 1981, money supply growth had slowed down (M1 rose by only six percent in 1981). Inflation, too, started to slow.

Since a substantial part of the inflation during this period was due to the expansion of base money, the rise in inflation can be viewed as an attempt by the government to finance its expenditures through the inflation tax. This was perhaps the most extensive use of the inflation tax by a government in Sri Lanka. Estimates by Edwards and Tabellini (1991) show that revenues accruing through the inflation tax between 1978–83 were 1.9 percent of GNP, compared with less than 0.7 percent during 1963–73 and 0.8 percent during 1973–78.

Fiscal Policy

To hold down the huge budget deficit, the government took steps in 1980 to raise government revenues, mainly through increases in import duties and other indirect taxes. However, the main thrust of the adjustment was expenditure restraint, which was to be achieved mainly through cuts in other capital expenditures while leaving the Mahaweli and housing projects virtually untouched. Cutbacks in 1981 on these two projects amounted to only 8 percent, while other projects were cut by 32 percent.

In 1982, the year of the first presidential election under the new constitution, fiscal stringency was relaxed. Government expenditures rose from 39.1 percent of GDP in 1981 to 41.3 percent in 1982. Both recurrent and capital expenditures went up. This loosening took place against a background of a further decline (16.7 percent) in the terms of trade, and widening deficits in the trade and current accounts. These deficits, measured in SDR terms, rose by 28 percent and 35 percent, respectively. Sluggish export growth in the face of rising import prices was behind the large trade deficit. Had it not been for higher earnings from tourism and an increase in worker remittances, the current account deficit would have been even bigger.

A major component of fiscal restraint came from the cuts in consumer subsidies, in particular the cuts in food subsidies. By maintaining the nominal value of

food stamps unchanged in the face of high inflation, real expenditure on food subsidies was drastically cut. This contrasted with the large transfers to loss-making state economic enterprises like Air Lanka. Many such enterprises had become overstaffed through the hiring of government supporters. Such transfers substantially counteracted the net impact of the food subsidy cuts.

The Pace of Trade and Exchange Rate Reforms Slows

There was no systematic attempt during this period to reduce imports through direct controls or through higher tariffs, although a few import items were added to the licensing list from about 1979 on. While balance of payments considerations played a role in these moves, they were basically motivated by the vulnerability of many state enterprises to foreign competition. An across-the-board levy of 10 percent on all items dutied at over 50 percent was introduced in 1980. This was ostensibly in order to gather funds to promote exports. In November 1982 some selective duty increments were applied to items already dutied at high rates. These were moderate, revenue-oriented duty changes applied to bring the trade balance into line. All in all, given the availability of very substantial external finance in the form of foreign aid and private transfers (mainly remittances), the government managed to avoid a retreat to import barriers as a way out of balance of payments pressures.

Although fiscal and monetary policies were used with some success to respond to immediate pressures on the balance of payments in 1978–82, the fundamental long-term issue remained that of stimulating growth of the tradables sector. Once again, as in 1973–75, Sri Lanka was unable to respond to the crisis by a rapid expansion of exports, even though export expansion was accorded high priority in the 1977 policy reform package.

The UNP regime accepted the view that the exchange rate should be an important policy instrument in promoting exports, and the value of the rupee in relation to the major currencies was adjusted daily to reflect changes in demand and supply. Central Bank intervention through the buying and selling of foreign currencies was limited at first, but then the Central Bank intensified its intervention and eventually abandoned (in November 1982) the practice of determining the exchange rate daily. There had been a gradual appreciation of the real effective exchange rate from 1979 onwards, except in 1981, when a marginal depreciation was recorded (table 5.1).

When exchange rate policy ceased to provide a stimulus for exports, the alternative was to strengthen the various financial incentives offered by the EDB. However, this indirect approach tended to founder because of severe institutional and financial constraints (see Cuthbertson and Athukorala 1990). While export development was theoretically considered a high priority area, in practice it received only secondary support from annual budgetary allocations because of the priority given to the politically appealing “lead projects.” This basic policy contradiction was discussed by the chairman of the EDB (Santiapillai 1981:1):

The pivotal role of exports in economic development . . . is not easily seen by politicians or bureaucrats. Foreign trade, somehow, is generally viewed as something distinct that does not directly touch the day-to-day lives of peoples as would, for example, a multipurpose river diversion scheme concerned with human resettlement, agricultural expansion, energy development, etc., all of which capture the attention of both the government and the people at large. This is at the root of the problems of mobilizing support for a concerted national effort to develop exports.

Except for tea, the trend in incentives measured through the real effective exchange rate (REER) over the period 1978–84 was clearly downward for broad export categories (table SA-17). This downward trend became more evident after 1980. The incentive structure continued to show a bias against traditional exports, although the degree of discrimination had been reduced by the exchange rate reforms of 1977. Within the broad category of nontraditional exports, manufactured exports were generally favored over nontraditional agricultural and mineral exports. The REER for gem exports declined sharply after 1977, and in 1981 was even lower than in the mid-1960s. Currency depreciation under the new exchange rate regime did not fully compensate for the abolition of the CRA scheme. Moreover, gem exports were not eligible for any of the incentive schemes.

According to one quantitative assessment of incentives to export-oriented and import-substitution manufacturing as of 1981, effective protection accorded to production for the domestic market was generally greater than that for exporting (Ratnayaka 1988). Overall, the favorable treatment accorded to manufacturing exports by various incentive schemes was minor when compared with the domestic market bias generated by high tariff protection. Judging from the subsequent changes in tariffs, export incentives, and the exchange rate, the antiexport policy bias intensified after 1981. Thus the favorable effects of trade liberalization in the early years of the UNP regime were eroded over time.

The basic problem with regard to export incentives arose from macroeconomic policy. For reasons associated with the public sector investment program, the maintenance of state enterprises, and the desire to restrain inflation, the government refused to make the currency devaluation that was necessary to avoid overvaluation. A favorable exchange rate policy would have given nondiscriminatory incentives to exports without the red tape and opportunities for rent-seeking that were inherent in Sri Lanka's complicated scheme of direct export incentives. On the other hand, the capital flows tended to appreciate the real exchange rate and might have counteracted any attempt to make the exchange rate a more realistic one through depreciation of the currency.

Employment and Wages

Surveys during this period indicated a considerable expansion in employment leading to a significant fall in unemployment (table 5.3). The PSIP itself, as well as the services and construction sectors, were the sources of substantial employment

Table 5.3 Various Estimates of Unemployment

<i>Year</i>	<i>Source</i>	<i>Unemployment as a percentage of labor force</i>
1953	Population Census ^a	0.8
1959/60	Survey of Employment ^b	10.5
1963	Population Census ^a	10.8
1964	Consumer Finance Survey ^c	13.8
1968	Labour Force Survey ^c	11.0
1969/70	Socio-Economic Survey ^a	14.0
1971	Population Census ^a	18.7
1973	Labour Force Participation Survey	18.1
1973	Consumer Finance Survey ^c	24.0
1975	Land and Labor Utilization Survey ^a	19.8
1978/79	Consumer Finance Survey ^c	14.7
1980/81	Socio-Economic Survey ^a	13.6
1981/82	Consumer Finance Survey ^c	11.7
1985/86	Labour Force and Socio-Economic Survey ^a	14.1
1986/87	Consumer Finance Survey ^c	15.5

a. DCS—Department of Census and Statistics.

b. ILO—International Labour Organization.

c. CBC—Central Bank of Ceylon.

Source: Authors' calculations.

growth. This was supplemented by rapid expansion of the labor-intensive textile and garment industry. Despite rapid economic growth and higher aggregate expenditures, real wages in the organized sectors (both public and private) showed a declining trend (table 5.1). On the other hand, the limited data available on daily wages for workers outside the organized sector suggest a marginal improvement. For example, real wages for casual farm labor reported by Wickramasekara (1983) indicate a rise of over 20 percent between 1977 and 1982. The increase in employment in the noninstitutional sector, combined with the substantial outmigration to the Middle East, is likely to have exerted some upward pressure on real wages, particularly in certain skilled worker categories. On the other hand, the decline in trade union power was probably a main reason for the poor wage performance in the institutional sectors.

Capital Flows, Income and Expenditure Effects, and Inflation

Much of the pressure on the price level and the real exchange rate during the 1978–82 period was a direct consequence of the higher domestic expenditures as-

sociated with the enhanced capital flows, which raised the demand for nontraded goods in the economy. A large literature has appeared since the late 1970s which analyzes the economic consequences of rises in expenditures brought about by favorable exogenous shocks. These studies were initially stimulated by resource booms, and this body of literature has come to be known as the Dutch disease literature (for an exposition and survey, see Corden 1984). We will draw on this literature in our analysis of the effects of capital flows in Sri Lanka.

These capital flows led to higher expenditures on domestic goods and services in a number of ways. Official capital inflows, which came as foreign aid and assistance, accrued directly to the government and were primarily meant to pay for the imports required by the PSIP. To the extent that they were spent on imports they did not have an impact on domestic prices. But there was a direct link between such official capital flows and the domestic expenditures of the government through the so-called counterpart funds, whereby the government agreed to spend matching funds on the domestic costs of the PSIP. Thus, every dollar of foreign capital inflow for the PSIP led to, in general, the addition of an equivalent amount in rupees to domestic government expenditures. Ultimately, such expenditures became the incomes of domestic private agents. The incomes of the private agents were directly supplemented by the remittances of migrant workers and the expenditures of tourists on domestic goods and services. Private agents can dispose of their higher incomes by spending on domestic (nontraded) goods and services and on imports, and by saving the remainder; the proportion saved depends on the extent to which the additional incomes are thought of as an increase in their permanent income, since most transient income is saved.

The evidence on the savings behavior of private agents during this period is consistent with the supposition that they thought that the increase in their incomes would be permanent. The private savings ratio had been 13.2 percent of GDP during 1970–76, but rose to 17.8 percent in 1977. In 1978 it fell to 16.5 percent and over the next five years it averaged 13.7 percent, only marginally higher than the 1970–76 figure. The 1977–78 figures probably reflect a lagged adjustment to the new situation.

There are several reasons why private agents might have concluded that their income increase would be permanent. Although the very high initial level of investment was not expected to be permanent, the investments themselves were widely expected to yield high future benefits, thus generating higher permanent incomes. Tourism appeared set to develop into a boom industry, and the country was enjoying the benefits of large remittances from overseas employment. In general, there was a mood of great optimism regarding the future of the economy.

Thus, the capital flows led to higher expenditures by the government as well as private agents. Some of these expenditures were made for the acquisition of nontraded goods and services, and exerted upward pressure on their prices. In an economy with full employment, higher demand for nontraded goods can be met only by drawing resources from other sectors, producing a rise in the relative prices of the nontraded goods—that is, a real exchange rate appreciation.²² Such a re-

source reallocation gives rise to “Dutch disease” effects as higher domestic spending leads to a contraction of the tradable sectors. If the exchange rate is fixed, the domestic prices of tradables in a small country are exogenously given. Hence, the rise in the price of nontradables not only changes relative prices but also raises the general price level. Thus, an increase in the price level, as observed in Sri Lanka, was consistent with the normal consequences of an absorption of capital inflows.

But there were also two factors in Sri Lanka that reduced such price pressures. First, as Lal (1985) has pointed out, trade liberalization that lowers the domestic price of imports will produce the required relative price change by means of a lower increase in the general price level than would otherwise occur. The trade liberalization of 1977–78 therefore dampened the inflationary pressure.

Second, the existence of considerable unemployment (to which we have referred earlier) would also have mitigated the price pressures, since the nontradables sector could expand to some extent by drawing on unemployed resources without having to bid higher for resources already employed in the tradable sectors. The decline in open unemployment and the relatively muted real wage increases observed during these years suggest that a considerable proportion of those who found jobs in the expanding nontradables sector may have come from the ranks of the previously unemployed. Even allowing for these factors, however, an increase in the price level was probably unavoidable. The nominal depreciation of the rupee during this period contributed to a higher price level by raising the price of tradables. This meant that the required change in relative prices had to be brought about by an even higher increase in the nominal price of nontradables, thus raising the general price level more than would have been the case if the nominal exchange rate had been fixed.

As would be expected from the above, the real exchange rate appreciated from 1979 onwards, and by the end of 1982 most of the real depreciation achieved by the 1977 devaluation had been lost (table 5.1). The resulting impact on domestic resource allocation was reflected in sectoral growth rates, which showed a rapid expansion of the nontradable sectors. The share of the services sector in the economy rose by nearly 10 percent during 1978–83. Services was the fastest growing sector of the economy in this period, followed by construction (table 3.4).

What was the impact of the terms of trade deterioration on these developments? As the figures on the magnitude of the terms of trade shock show, even if a part of the fall could be ascribed to normally expected volatility, the impact was large enough to be translated into a significant reduction in permanent income.

The most influential analysis of capital flows into Sri Lanka during this period is that by Lal (1985). The basic thrust of his analysis was that the large current account deficits and the appreciation of the real exchange rate were necessary to absorb the capital inflow and did not signify a current account problem that had to be corrected by expenditure switching and absorption reduction policies. Even the loan component of the aid flows was considered desirable, since the loans were made on concessional terms and were used to finance investments. According to Lal’s empirical analysis, the magnitude of the observed rise in the price level and

the appreciation of the real exchange rate were consistent with the changes required to absorb the capital flows.

We will return to the issues relating to the investment program and its financing in our discussion of long-term growth in the next chapter. Here, we simply note that the empirical analysis ignored the terms of trade shock, and that in any case the shock could not have been handled within the framework of his analytical model, which was based on the aggregation of importables and exportables into a single composite commodity. Given the magnitude of the change in terms of trade, such an aggregation was invalid for an empirical investigation of macroeconomic performance during the 1978–82 period.²³

As described earlier, the government maintained its expenditure levels until 1981, when certain spending cuts were made. But even these were partially reversed in 1982 in the period prior to the election. In any case, the 1981 reductions in spending were not sufficient to compensate for the real income losses flowing from the terms of trade fall, and the “autonomous” capital flows were inadequate to finance the resulting increase in the current account deficit. This was reflected in the greater resort to commercial borrowing and the related rise in the debt service ratio. Between 1980 and 1983 the debt service ratio rose from 12.9 to 21.8 percent. Thus, the real exchange rate and price level changes observed during this period were the direct consequences of a deliberate government policy to maintain the level of real expenditures. They were not merely the exchange rate and price level changes required to absorb the autonomous capital flows.

A regression analysis of the movements of the real exchange rate during the 1970–87 period confirms that capital inflows and government expenditures tended to appreciate the real exchange rate (Athukorala and Rajapatirana 1990). Unfortunately, terms of trade effects could not be isolated because of econometric problems in estimating the model.²⁴ Bandara (1989), who conducted simulation experiments with a computable general equilibrium (CGE) model, decomposed the effects of the capital inflows and the terms of trade decline. The results confirm that the capital inflows and terms of trade decline had opposing effects on the real exchange rate (and on certain other key variables). Further analysis has shown that there would have been substantial declines in consumption, household incomes, and real wages, and a significant stimulus to the major export industries via a real exchange rate depreciation if the expenditure cuts had been large enough to offset the income effects of the terms of trade fall (Bandara and Jayasuriya 1991).

The result of the decision not to cut spending was that the real exchange rate continued to appreciate rather than depreciate (except for a marginal depreciation in 1981). Hence, the Dutch disease effect on the tradable sector was allowed to persist. The poor performance of the export sector must be seen in the context of this policy of nonadjustment, or only partial adjustment, to the terms of trade decline. The traditional export crops, tea and rubber in particular, continued to stagnate. Commodity specific real exchange rates appreciated, while producer margins remained depressed. There was no significant improvement in exports of other manufactures or of nontraditional agricultural products. In the case of tex-

tiles and garments, two factors unrelated to the domestic exchange rate and trade policy changes led to expansion of exports (Athukorala 1989). These were the protected world-market share ensured by the quota system under the Multi-Fibre Textile Agreement and the cost advantage achieved through lower wages.

Regression analysis of short-run export performance using commodity specific real exchange rates supports the view that trade and exchange rate policies during this period had adverse implications for the promotion of nontraditional exports in general and manufactured goods in particular (see appendix I). There were some limited attempts to counteract these effects, and the reduction in taxes on tree crop exports gave some relief. But these efforts fell short of what countries such as Malaysia and Indonesia did when they enjoyed temporary resource booms (Corden 1987; Barlow and Jayasuriya 1987).

Political Instability and Faltering Growth

The Sri Lankan economy had not fully adjusted to the shocks of the 1978–82 period when the terms of trade improvement eased the immediate pressures. But political conditions deteriorated sharply in 1983. This makes an overall assessment of the adjustment process difficult. However, the contrasts between this period and the 1973–75 crisis period are striking.

While the decline in the terms of trade during the 1978–82 period was much larger than the decline during the 1973–75 period, the economy suffered only a relatively minor slowdown in overall growth performance. Indeed, in the popular consciousness the 1978–82 period is not seen as a period of stress, whereas the 1973–75 experience left strong negative memories. GDP growth was maintained at a respectable 5 percent level per annum throughout the 1978–82 period, and private consumption also grew throughout the period, except in 1980. Public consumption did fall somewhat during 1980–81 but grew thereafter. In absolute terms, total investment rose almost uninterruptedly. Was this relatively benign outcome a result of a far superior handling of economic shock through the use of more appropriate policies? Or, as some would argue, was it mainly a result of the easy availability of concessionary capital inflows?

The rise in concessionary capital inflows and remittances did make a fundamental difference. Despite the terms of trade deterioration, the country was able to sustain dramatically higher levels of imports and finance the investment surge without an inflationary crisis and with only a relatively minor buildup of high-cost external debt. The enormous importance of foreign finance can be illustrated by a few figures. Average import volume during 1980–84, after the terms of trade decline had already taken place, was 60 percent higher than during the 1978–79 period; and that, in turn, was 45 percent higher than the 1970–77 average. On the other hand, the average export volume index during 1980–84 was only 10 percent higher than that of 1978–79.²⁵ To finance the average level of imports during 1980–84 at constant terms of trade, export volume would have had to be 50 percent higher than it actually was. Clearly, the surge in the GDP growth rate in the

immediate post-1977 period was not brought about by an expansion of exports due to trade and exchange control liberalization. Instead, it had a distinctly Keynesian character, being brought about by the massive rise in government expenditure.

The burst of inflation during the 1978–82 period, while not high by most developing country standards, was nevertheless unprecedented in Sri Lankan history. But by 1982 there were signs that inflationary pressures were abating. All of the price indices showed inflation for the year falling to 10 percent or less.

The Central Bank attributed this slowdown in large part to its restrictive credit policies. However, political uncertainty accompanying the 1982 presidential election probably also played an important role in reducing credit demand during the latter part of the year. Indeed, the targets established by the Central Bank in 1981 as part of the National Credit Plan were well above actual demand. A substantial buildup of excess liquidity in the commercial banking system then led the banks to reduce interest rates on time deposits. Also, the inflationary pressure generated by the investment program may have been moderated by the negative income effects of the terms of trade deterioration.

The emergence of the world economy from the 1980–82 recession brought an improvement in Sri Lanka's terms of trade. The impact of increases in world market prices of Sri Lanka's exports was considerable—export earnings in SDR terms rose by 8.2 percent in 1983, while the terms of trade rose by 16 percent (based on a 1978=100 index). However, the full benefits of the favorable world market situation were lost because of continuing poor performance in the export crop sector.

There were also negative developments in the services account. First, debt servicing soaked up an increased amount of export earnings, and the resort to short-term commercial borrowings (particularly after 1980) aggravated the debt service burden. Second, widespread violence against the Tamil minority in Colombo and other Sinhalese-dominated areas reversed the strong growth in the tourist sector.

Despite these negative factors, the current account deficit declined in 1983. Although there was a 12 percent decline in the inflow of direct foreign investments and other short-term and long-term capital inflows, a marginal improvement in the overall balance of payments took place and net external reserves rose. There was a much greater improvement in the balance of payments in 1984, caused mainly by the tea price rise. Continuing growth in worker remittances from the Middle East also helped to improve the current account despite the decline in tourist numbers. Given these favorable changes, the country no longer faced the balance of payments pressure of the 1979–82 period, and other issues took center stage.

Chapter Six

Macroeconomic Policies and Long-Term Growth

In this chapter we turn to the central concern of this study by examining how policy responses to the macroeconomic crises may have affected long-term growth. We proceed by analyzing changes in a number of broad, overlapping areas that are likely to influence long-term growth: the level, nature, and efficiency of investment, the nature of domestic savings behavior, the functioning of economic institutions, and the sociopolitical environment. The latter factors can be thought of as influencing growth through their impact on the level and efficiency of investment. Our interest here is not the quantification of the absolute or relative contribution of various factors. Rather, we seek to obtain some *insight into how short-term crisis management policies influenced the behavior of key variables in a manner that affected long-term growth.*

Investment and Growth

The selection of the above variables for our analysis is based on the generally accepted view that investment level and its efficiency are key determinants of output growth. However, the underlying theoretical justification for such a choice has only recently been developed in a rigorous manner; the traditional neoclassical growth model implies no role for economic policy as a determinant of the long-run growth rate. We examine the role of investment and its efficiency using an equation based on Scott (1989), which hypothesizes that changes in long-run growth rates are due to changes in the rate and efficiency of investment. In this equation we regress the moving average of the rate of investment over three previous years and a number of other variables that may have affected investment efficiency on the rate of growth of real output in the nonresidential business sector.

Note that the equation, while consistent with the Scott model, is consistent with several other models as well; changes in investment can have a positive impact on growth rates in the relatively short run even in the neoclassical model. The estimated function is presented in table 6.1 (for details, see appendix I).

Our results are consistent with the view that the rate of investment is a key determinant of the economy's growth rate. The coefficient of the trade liberalization index has the expected (positive) sign and is significantly different from zero, suggesting that a liberal trade policy stance promotes growth. This finding is directly relevant for our discussion of the effects on growth of trade restrictions used as a macroeconomic policy tool. (A model was also estimated with the ratio of private sector investment to total investment as a separate variable, but it was highly correlated with the trade liberalization variable and its coefficient was statistically insignificant.) The investment scale variable (S^2) has a statistically significant coefficient with the expected (negative) sign. Again, this is consistent with the hypothesis that large increases in the rate of investment lead to reduced investment efficiency as relatively inefficient investment projects are implemented.

Table 6.1 Determinants of the Rate of Growth of Real Output (G), 1950–83, Regression Results

Rate of investment (S)	0.424*
	(6.72)
Investment-scale variable (S^2)	-1.22*
	(4.90)
Slope dummy of S for trade liberalization(T*S)	0.0244
	(3.35)
Rate of change of capacity utilization (U)	0.177**
	(2.30)
Intercept dummy for output disruption (D71)	-0.054
	(4.17)
Intercept dummy for 1950s (D50s)	-0.046*
	(-5.42)
Intercept dummy for civil war 1987–89 (D87–89)	-0.029*
	(3.48)
\bar{R}^2	0.68
F	13.13*
DW	2.40

Note: Growth of real output (value added) in the nonresidential business sector (defined as total GDP minus the sum of the three national account categories, ownership of dwellings, public administration and defense, and other services).

The t-ratios of regression coefficients are given within parentheses, with the level of significance denoted as ** = significant at the one percent level and * = significant at the five percent level. For details on model specification and data sources, see the appendix.

Source: Authors' calculations.

The implications of this regression equation for long-run growth must be interpreted with some caution. Growth rates are clearly influenced in the short run by investment, but no strong conclusions can be drawn regarding the long-run effects. But to the extent that growth is stimulated by increases in investment, the importance of investment and its efficiency are emphasized in these results. Now we turn to an analysis of the behavior of domestic savings, a major determinant of investment in developing countries like Sri Lanka.

Savings Behavior

In principle, of course, investments can be financed with domestic or foreign savings if a country has access to the world capital market. But domestic savings remain a major determinant of the capacity for investment because the cost of foreign capital rises with the scale of borrowing due to perceived lending risk. (In any case, domestic capital markets are insulated from the world capital market in many developing countries, and private agents do not have direct access to the latter.) Hence, the level of domestic savings strongly influences the cost of capital. By lowering the domestic cost of capital, higher domestic saving reduces the level of foreign borrowings, and, given an upward-sloping foreign supply curve, lowers the cost of foreign borrowings as well. These considerations applied to Sri Lanka, even after the 1977–78 reforms. We estimated separate domestic savings functions for total (private plus public), private, and financial savings for the 1960–87 period to explore their behavior in a longer-term context.

The estimated savings functions are presented in table 6.2. The rationale for the chosen specifications and the estimation procedures are discussed in appendix I. Here we draw attention to some of the main points that emerge from the analysis.

First, the results are clearly consistent with the hypothesis that foreign savings crowded out domestic savings, both total and private. The coefficient of foreign savings (capital inflow) is negative and significant in both the total and private domestic savings functions.

This has particular relevance for analysis of the long-term implications of foreign capital flows. However, a caveat is in order. It is theoretically possible that the causation goes the opposite way—that is, that the inadequacy of domestic savings may have forced greater reliance on foreign savings. The results also suggest that domestic policies, particularly those associated with financial repression, significantly influenced domestic savings. Private savings (including private financial savings) have been strongly influenced by the real interest rate. In the Sri Lankan context, the availability of foreign savings probably reduced the pressure to change financial repressionist policies that constrained domestic savings, thereby helping to maintain a low savings rate. On the positive side, the expansion of the banking network stimulated financial savings.

Table 6.2 Determinants of Savings: Regression Results

<i>Variable</i>	<i>DS</i>	<i>DPS</i>	<i>FNS</i>
Constant	7.48** (3.83)	2.38 (0.64)	-3.39** (2.78)
PGDP	1.89** (7.00)	1.22** (2.57)	1.55** (4.59)
GDPR	0.83 (1.62)	0.95 (1.23)	
(1 + RSTD)	1.68 (1.37)	1.98* (2.28)	6.13* (2.23)
D*(1 + RSTD)	-1.10 (0.11)	0.26 (0.19)	-1.99 (0.83)
(1 + PE)		(1.59)	5.84
D*(1 + PE)		(0.16)	-0.45
FS	-0.05** (4.81)	-0.04* (2.10)	
FIR	3.54** (4.81)	3.37 (1.69)	
\bar{R}^2	0.96	0.92	0.84
F	112.57**	51.35**	30.22**
DW	2.16	1.94	1.60

Variables: DS = Real total domestic savings; DPS = Real domestic private savings; FNS = Real Financial Savings; PDGP = real per capita GDP; GDPR = Real GDP growth; RSTD = Weighted average real interest rate on savings and time deposits; PE = Expected inflation (proxied by the rate of inflation with a one-year lag); FS = Real foreign savings; FIR = Financial intermediation ratio (M3 as a percentage of nominal GDP); D = trade liberalization dummy (one for 1978–87 and zero for other years). All variables except growth rates are expressed in logarithms.

Note: The t-ratios of regression coefficients are given in parentheses. The level of significance is denoted as ** = significant at the one percent level and * = significant at the five percent level. For details on model specification and data sources, see appendix I.

Source: Authors' calculations.

Overall, our savings functions suggest that the general policy of financial repression and the associated low interest rate policies hampered the mobilization of domestic savings in general. Given financial repression, inflation lowers expected real interest rates, since the banks are unable to make upward adjustments in line with market forces. In these circumstances it can be argued that the general reluctance of the government to utilize inflationary policies probably helped avoid a poorer private savings performance.

Private Investment

In previous chapters we have discussed the political and policy parameters influencing public sector investment decisions. To gain more insight into private sector investment behavior, we estimated a private investment function for the period 1960–82. This is presented in table 6.3.²⁶ Details about the theoretical rationale for the specification and the estimation procedure are given in appendix I. Recall that credit to the institutional sector was usually rationed because of the interest rate and other regulations. It can be seen from the estimated function that a major influence on private investment was the availability of credit from the institutional sector. The short-run (one-year) elasticity of real private investment with respect to loanable funds is 0.63. This figure, when combined with the coefficient of the lagged dependent variable, yields a long-run elasticity estimate of 2.17.

The results also support the hypotheses on the positive impact of income growth and the negative impact (the crowdingout effect) of public sector investment on private investment. The regression results provide no evidence that higher interest rates and the resulting high cost of investment inhibited private investment, as asserted by Jayawardana, Maasland, and Radhakrishnan (1987) and Roe (1982).

Arguably, the role of financial repression was a key influence on private investment, since it resulted in credit rationing to the private sector. Given that the

Table 6.3 Determinants of Private Investment, 1960–82: Regression Results

Constant (C)	-0.33 (0.25)
Institutional credit to the private sector (ICP)	+0.63** (3.52)
Lagged public-sector fixed investment (PBIV(-1))	-0.34* (2.26)
GDP growth (1 + YR)	+0.05** (3.14)
Index of rental cost of capital (RC)	-0.07 (1.17)
Lagged private investment (PRIV(-1))	+0.71** (4.73)
\bar{R}^2	0.92
F	49.35
DW	1.82

Note: All variables are measured at constant (1980) prices and expressed in logarithms. The t-ratios of regression coefficients are given in parentheses. The level of significance is denoted as ** = significant at the one percent level and * = significant at the five percent level. For details on model specification and data sources, see the appendix.

Source: Authors' calculations.

private sector had to rely entirely on domestic sources of credit because of foreign exchange regulations, such credit rationing probably constrained private investment throughout the 1960–82 period, except during brief periods (such as in the 1973–74 period) when the constraints were nonbinding. As described earlier, the public sector conscripted a large chunk of institutional savings throughout the period, and it is plausible that this led to financial crowding-out, causing a decline in private investment.

We draw on this analysis of the determinants of investment and savings to examine the impact of crisis management policies on savings and investment patterns, and on the efficiency of investment.

The 1973–75 Crisis: Long-Term Effects

In chapter 4 we described how the policy response to the 1973–75 crisis involved a sharp reduction in the level of investment. Gross Domestic Fixed Capital (GDFC) declined from an average of 15.8 percent of GDP during the 1966–72 period to 13.3 percent during 1973–75. If cuts in education expenditure are included, the decline was even more severe. Total expenditure on education fell from an average of 4.4 percent of GDP during 1966–72 to 3.0 percent during 1973–75.

However, we cannot conclude that this reduction in investment necessarily had a significant negative effect on long-term growth. Various factors suggest that the negative effects, if any, may not have been large.

First, the fall in investment lasted a relatively short time. As economic conditions began to improve, investment recovered. And after the change in regime in 1977, it took a quantum leap to a level unmatched by any earlier period.

Second, when the efficiency aspects of the investment patterns and their changes are considered the overall impact on growth may have been only marginally adverse, or even positive. While there was an overall reduction in both public and private sector investments, the sharpest cuts were in the public sector (table 5.1). Public corporations' investments declined from an average of 2.6 percent of GDP during 1966–72 to 1.5 percent during 1973–75.

There is considerable evidence that many public sector enterprises (PSEs) were highly inefficient. These inefficiencies flowed from three main sources: (a) the protectionist import-substitution strategy resulted in the establishment of PSEs in industrial sectors where Sri Lanka had no comparative advantage; (b) such enterprises typically were granted easy access to public funds via budgetary transfers and preferential access to bank credit; and (c) they often enjoyed a degree of monopoly power in markets insulated from competition through protection or regulation. Under these conditions, the allocative inefficiencies arising from the trade regime were aggravated by various types of x-inefficiencies.

Continued growth of such PSEs through additional investments could have enlarged the inefficiencies, with "immiserising" implications. There is evidence that

the “inefficiency spillover effects” of such industries were substantial, particularly since import compression policies were implemented with a distinct public sector bias in the allocation of imported intermediate goods. Since many PSEs were engaged in intermediate goods production (steel, tires, plywood, paper, and cement), the production costs of downstream user industries went up. In an inquiry into the operations of the steel corporation, which supplied about 50 percent of domestic rolled steel products in 1973, Sirisena (1975) found that domestic user costs, on average, were 41 percent higher for the steel corporation’s metal than for comparable, or perhaps even better quality, imported steel. An additional longer-term consequence of such policies was to raise the import dependency of manufacturing industries. Analysis of input-output tables for 1965 and 1970 showed that 34 out of 41 manufacturing industries reported increases in total import content because of greater use of locally processed imported inputs (Athukorala 1981). A similar exercise cannot be undertaken for the crisis period itself because of an absence of data. But since the basic structure and mode of operations of PSEs remained virtually unchanged during the crisis years, it is safe to conclude that this would have applied also during that period.

Therefore, to the extent that public sector investment in inefficient PSEs declined, there may have been little or no negative impact on long-term growth. In fact, we cannot even rule out the possibility that such cuts were beneficial. However, where such cuts fell on infrastructure and efficiently utilized capital stock, such as trees on state-owned plantations, the effects would have been negative. In the absence of appropriately desegregated data it is not possible to quantify the extent of such cuts, but anecdotal evidence suggests that the road system, for example, deteriorated badly during this period.

In table 6.4 the incremental capital/output ratios (ICORs) for this period are presented. There is no discernible trend in that ratio until the end of the 1970s and no evidence of a marked deterioration in the immediate aftermath of the crisis. Of course, this measure is too crude to fully reflect the longer-term efficiency consequences of past investments.

The generally depressed level of overall private investment is explained by the adverse economic and political climate, but the decline in total investment was minor. There is evidence that there were changes in the composition of private investment during this period, as shown by the expansion of nontraditional exports and the development of new import-substitution sectors, particularly in agriculture. Again, the long-term growth consequences of these changes require careful analysis. These changes, particularly the growth of nontraditional exports, have been cited to support the view that, despite import controls and the absence of a nominal devaluation of the exchange rate, export dynamism was being generated through selective incentives (Kappagoda and Paine 1981; Hewavitharana 1975 and 1980). Was this expansion of nontraditional exports a reflection of structural changes in the economy toward dynamic long-term export growth based on the country’s comparative advantage? We believe that the answer is no.

Table 6.4 Gross Domestic Product (GDP), Gross Domestic Fixed Capital Formation (GDFC), and Incremental Capital/Output Ratio (ICOR), 1961–87
(1980 prices, millions of rupees)

Year	GDP	GDFC ^a	ICOR ^b
1961	29,076	3,330	5.7
1962	30,122	3,592	3.1
1963	30,744	4,158	5.7
1964	32,207	4,018	2.5
1965	33,218	3,604	3.9
1966	34,418	4,330	3.0
1967	35,849	4,883	3.0
1968	38,525	5,312	1.8
1969	40,371	6,975	2.8
1970	41,963	7,941	4.3
1971	41,937	7,158	— ^c
1972	45,222	7,828	2.1
1973	46,816	6,432	4.9
1974	48,667	7,654	3.4
1975	50,950	7,931	3.3
1976	53,211	8,620	3.5
1977	55,244	7,980	4.2
1978	59,098	11,848	2.0
1979	62,880	16,239	3.1
1980	66,527	22,465	4.4
1981	70,386	19,545	5.8
1982	73,975	22,747	5.4
1983	77,645	22,434	6.1
1984	80,800	20,866	7.1
1985	84,438	20,115	5.7
1986	88,194	20,866	5.3
1987	90,364	21,084	9.6

a. Current price data deflated by GDP (tradables) deflator.

b. $ICOR_t = [GDP_t - GDP_{t-1}] / GDFC_{t-1}$

c. ICOR not defined due to negative GDP growth.

Source: Based on data from the Central Bank of Ceylon, *Review of the Economy* (annual).

First, there is much anecdotal evidence that export revenue from nontraditional exports was substantially inflated, though it is not possible to quantify precisely its extent. Nontraditional export revenues could be partially utilized to finance imports under the CRA scheme. Under a highly restrictive trade regime, this attracted a scarcity premium to such exports. CRA credits to gem exporters, for examples, fetched a premium of 150 to 200 percent (Jayawardena 1982). This in-

duced widespread overinvoicing of exports. In the case of gem exports, which showed the largest growth, the higher figures were to a large extent a reflection of the channelling of previous illegal exports into legal (recorded) trade because of the enhanced profitability of legal exports.

Second, some of the expansion came from the shifting of investment to industries that did not enjoy any comparative advantage; the growth of many nontraditional agricultural commodities, for example, was at the expense of traditional plantation crops. Nor is there any evidence that the resulting diversification of the export structure made export earnings more stable, since the prices of many of the nontraditional agricultural exports were positively correlated with those of traditional exports (Jayasuriya and Barlow 1986).

Third, in the case of manufactured exports, about 85 percent of such exports in 1975 came from a handful of multinational subsidiaries which temporarily diverted some of their domestic sales to the world market in order to become eligible for import entitlements under the CRA scheme. Most of these “new” exporters virtually disappeared after the 1977 trade liberalization, which raises a question about their intrinsic competitiveness (Athukorala 1984). In general, as is well known, selective promotion of exports involves resource reallocation to favored sectors. Without systematic analysis of such “backwash” effects, it is not possible to evaluate “export success” meaningfully. The nature of the trade and exchange rate regime suggests strongly that the growth of nontraditional exports and newer import-substitution activities often took place at the expense of sectors which clearly had a comparative advantage.

Thus, the short-term crisis management policies designed to expand exports tended to enlarge the efficiency costs of the incentive structure and in many cases stifled the country’s internationally competitive sectors.

The cuts in investment, particularly public sector investment, encouraged moves by the government to increase domestic savings, but these moves were hampered by financial repressionist policies. Econometric analysis suggests that substantial increases in savings, particularly private sector savings, could have been achieved with more attractive interest rates on savings. Even the limited interest rate increases that were implemented and the expansion of the banking system facilitated a higher level of financial savings.

But higher levels of financial savings within the institutional sector, under conditions of credit rationing and public sector bias, would not necessarily have helped private investment much. The econometric evidence on crowding out suggests that cuts in public sector investment would have at least mitigated the adverse conditions for private investment by reducing the public sector claims on savings.

The policy response to the 1973–75 crisis—the tightening of already stringent controls on many markets and the extension of controls to new markets—certainly had severe short-term effects on economic activity. But, again, it is questionable whether they had any sustained effects on long-term growth. After all, they too lasted for only a relatively short period of time, being completely or substantially

removed by the policy reforms of 1977–78. Indeed, some measures, such as controls on domestic rice trade, were removed even earlier.

Despite the brief lifespan of those measures, we would contend that they had a major impact on the longer-term evolution of the Sri Lankan economy. One reason is that Sri Lanka avoided creating a large external debt, whether by design or by force of circumstances. But probably the longer-term impact came primarily from the political consequences of the crisis management policies. They facilitated the demoralization of the traditional left, the weakening of the trade unions, and the election of the UNP government in 1977 on a program that openly proclaimed a fundamental break with past economic policies. Without the first two conditions the implementation of the new policies would have been enormously difficult.

The economic hardships suffered by the population during the 1973–75 period, which did not entirely disappear even after the immediate crisis had passed, profoundly influenced the political environment. In the eyes of large sections of the population, “socialism” became identified with shortages, black markets, controls, rising unemployment, and large and sudden price increases which cut living standards overnight. Popular dissatisfaction with government policies led to internal conflicts and splits within the constituent parties and weakened their capacity to withstand the challenge from the UNP. When the traditional defenders of consumer subsidies themselves discarded the principle that such subsidies were sacrosanct, a fundamental change took place in the political arena. The attempts to justify sharp price increases and the rationing of many commodities focussed attention on the links between the domestic and the world economy. The illusion that the Sri Lankan economy could insulate itself from the world market and follow a path of self-reliant development was rudely shattered by the exposure of the vulnerability of the economy to external developments, even after decades of import-substitution policies. Greater popular awareness of international economic developments also highlighted the fact that Sri Lanka, which had one of the highest standards of living in Asia during the 1950s, had fallen well behind nearby countries, such as Singapore, which had pursued liberal economic policies. In these circumstances, the program of liberal economic policies presented by the UNP appealed to large sections of the population. The widespread appeal of an “open economy” program produced a massive electoral victory for the UNP in 1977. It provided the new government with the political legitimacy and popular support essential for implementing fundamental policy changes. It is in this sense that the policies adopted during the 1973–75 crisis were of major long-term significance.

The 1978–82 Crisis: Long-Term Effects

In terms of GDP growth and investment, the post-1977 decade was sharply different from the preceding decades. The basis for these developments was laid during

the 1977–78 period, which started with important trade and exchange rate reforms and was followed by capital market reforms and the dismantling of certain consumer subsidies. While the effects of some of the policy reforms were modified by the countervailing consequences of other policies, some of the key elements of those early reforms were retained during the crisis years and survived the decade of the 1980s.

In assessing the long-term impact of policies adopted to deal with the shocks inflicted by the investment drive and the terms of trade shock, we will look first at investments, with particular attention to their efficiency aspects. As described earlier, the investment boom was primarily, but not solely, a public sector phenomenon. Private sector investments rose to more than 13 percent of GDP after 1978, which was well above historical levels. Since the magnitude of the investments was so large, the key question in analyzing their long-term impact is, how efficient were they?

The most commonly used indicator of investment efficiency on an economy-wide basis, the incremental capital/output ratio (ICOR), showed a steady decline in the efficiency of capital utilization throughout this period (table 6.4). Admittedly, the ICOR is a crude indicator of efficiency, particularly when the investments have long gestation periods. But it is striking that the figures show a consistent trend of increasing inefficiency.

Indeed, many of the public sector investments, including the house-building program, were chosen and implemented with little or no attempt at rigorous benefit-cost analysis. Political imperatives were paramount in the choice of investments, a process facilitated by the availability of generous donor funds. The capacity of the administrative system to undertake careful assessments of alternative projects was limited, and the flood of foreign aid overwhelmed the system. In any case, it is not surprising that many projects of low (or even negative) benefit were funded. The massive leap in investment over such a short period of time was bound to lead to rapid exhaustion of higher return investments, given the constraints imposed by an incomplete infrastructure, shortages of domestic skill, and weakness in other domestic inputs. Clearly, a more staggered pattern of investment growth would have been more desirable from an efficiency viewpoint. But as discussed in chapter 5, there were political reasons for the PSIP. The important economic argument was that donor funds, which were either grants or loans on highly favorable terms, should be locked into long-term projects immediately to ensure they continued. Since these funds were a free, or nearly free, gift, the notion was that the country was likely to gain some advantage even if the projects were not very efficient.

While the assertion that foreign aid flows would have dried up unless locked-in through long-term projects may have had some validity, it is important not to overlook the large domestic costs of the projects when assessing the net benefits. Although most imported inputs, and in certain cases even a part of domestic costs, were funded by foreign donors, the “local counterpart” funds allocated to these projects were extremely large and sometimes exceeded the amount of foreign

funding (table 5.2). This had three important effects. First, despite the availability of foreign funds, budget deficits that had to be financed from other sources rose. Second, the commitment of funds to these projects effectively precluded the financing of potentially more rewarding investments. Third, because the government as a whole as well as leading political figures had closely identified themselves with these projects, the government's ability to respond flexibly to macroeconomic imbalances was hampered. Such rigidities were aggravated by the interest that donor agencies had in maintaining projects to which they had already committed funds. When expenditure cuts were made, they tended to fall more heavily on other, sometimes more socially desirable, projects. Further, there was a continuation of support for the expansion of many of the inefficient public sector enterprises that were mainly official conduits for the dispensation of political patronage, particularly in the form of jobs. As a consequence, they became even more inefficient and required substantial government transfers. Thus, these investment programs imposed substantial direct costs on the economy.

There were important indirect costs as well. These were the Dutch disease effects on the tradables sectors associated with capital inflows and higher domestic expenditures discussed in the previous chapter. By themselves, these would have tended to appreciate the real exchange rate, thereby reducing the profitability of the tradables sectors. But there were opposing effects on the real exchange rate due to the fall in national income brought about by the terms of trade deterioration. The decision of the government to maintain the growth of real expenditures, particularly on the PSIP, ensured the appreciation of the real exchange rate. Thus, the real exchange rate effects of the investment program tended to offset some of the incentives given to the tradable sectors by the trade and exchange rate reforms, whose goal had been to raise the profitability of tradable goods production. Those reforms, together with financial market reforms, did achieve that aim, as indicated by swift depreciation of the real exchange rate. But subsequent real appreciation eroded these incentives.

This focus on the role of real exchange rate appreciation ignores the potential long-term benefits for the production of tradables arising from infrastructural investments. The relevant question from the longer-term viewpoint is whether the adverse real exchange rate effects on the tradable sectors were outweighed by the expected future gains from the investments. Again, this depends on the efficiency of investment.

Recall that maintenance of the investment program forced the government to obtain commercial loans, which came at market rates of interest. Hence, at the margin the investment program had to generate returns that exceeded market interest rates if they were to be justified on economic grounds. The nature of the programs, with large indivisibilities built in, left little room for scaling down the more inefficient components; this further reduced their effective rate of return. Thus, the real exchange rate appreciation that imposed costs on other tradable sectors via Dutch disease effects appears to have had few, if any, significant offsetting beneficial effects. There is strong evidence that the major investments were inefficient.

Even the *ex ante* appraisal of the accelerated Mahaweli project in 1979 suggested that the overall rate of return would be no more than 11 percent, a rather low figure.²⁷ Evaluations of various components of the Mahaweli project suggest that they produced very low—and even negative—returns because of large cost overruns and declining prices for rice and oil (World Bank 1988).²⁸ There are no comparable evaluations of the other major public sector investment programs, such as the housing program and construction of the new capital. In each of these cases the resulting macroeconomic effects reinforced the appreciation of the real exchange rate. Hence, the timing of those programs is certainly debatable.

The only agricultural sector that grew steadily after 1977 was the rice sector (table SA-6). But this was due mainly to a more favorable price environment resulting from the deregulation of rice marketing, reductions in consumer food subsidies, the adoption of high-yielding varieties, and positive discrimination for rice production provided by a range of implicit and explicit subsidies.²⁹ The contribution of the Mahaweli project to rice production has been relatively minor and was achieved at very high cost (World Bank 1988).

The indirect costs of maintaining the large public sector investment program also included the crowding-out effects on private sector investment via the rationing of investment capital. The higher profitability of tradable sectors resulting from trade reform might have attracted larger private sector investment if crowding out by the public sector had been absent. But, as indicated by the regression results on private investment behavior, such crowding out probably did occur and may have imposed additional long-term costs on the economy, given the inefficiency of many public sector investments. An additional source of costs to the economy was the stimulus given to rent-seeking activities by the PSIP.

Policy Responses, Income Distribution, and Political Stability

We now turn to the relationship between macroeconomic policies and their impact on income distribution and political stability. This has become an issue of great concern in the Sri Lankan context, due to the social and ethnic conflicts that erupted in the 1980s. Clearly, political stability is of central importance for long-term economic growth, and the political crisis of the late 1980s dealt a severe blow to the prospects for Sri Lanka's economic growth. The cost of defense expenditures alone has risen from less than one percent of GDP to nearly six percent.³⁰ Therefore, it is natural to raise the question whether the policies pursued in the post-1977 period contributed to the aggravation of social and ethnic conflicts through their distributional effects. A full answer to this question is beyond the scope of this study and is not attempted here. However, we do examine the available evidence on the distributional impact of the policy measures on income distribution as a contribution to a broader assessment of the issue. In Sri Lanka's case, the

overall changes in income distribution as well as the inter-ethnic distributional changes are of relevance.

Any discussion of the distributional issues must be based on the clear recognition that fundamental changes in the economy had become unavoidable by the mid-1970s. By then, the economy had reached an impasse. Generous consumer subsidies, rising living standards, and employment growth were no longer sustainable in the framework of the strategy pursued since independence. But all far-reaching changes in economic policy have distributional consequences. Indeed, often the very objective of such policy changes in a market economy is to produce distributional changes via changes in relative prices and intersectoral profitability. A failure to change course and lead the economy out of stagnation can itself push social and political tensions to the breaking point. If such changes produce general economic growth, absolute levels of income and welfare can rise even if relative inequalities worsen. By appropriate targeting of transfers, undesirable distributional consequences can be minimized, even in the short run.

On the other hand, a community will maintain social peace and stability in the midst of sharp changes in income distribution and immediate hardship only if the people can be persuaded of the long-term benefits of such changes. The credibility of the program and the policies becomes bound up with the trust and confidence that is inspired by political leadership. It is difficult to make generalizations about the impact of crisis management policies on the evolution of the political conflicts without an analysis of the specific policy package and the concrete conditions under which they were implemented. This is particularly so in our case, since the ethnic and social conflicts that erupted in the 1980s have deep historical roots. In particular, the stagnation of the economy in the later postindependence period had created a fertile ground for the maturing of conflicts. Long-term social harmony could be achieved only in the context of a dynamic, growing economy. An examination of the impact of post-1977 economic policies on income distribution within and across communities can shed some limited light on whether those policies aggravated the already simmering tensions to the breaking point.

Further, it is important to recognize that the observed changes were the result of the total package of policies and programs. In most discussions of the income distribution issue, there has been a tendency to focus on the trade and exchange rate reforms and the consumer subsidy cuts. These, however, were only a part of a whole range of policy measures, including the huge public sector expenditure surge. It is naive and misleading, for example, to attribute all income growth to policy reform alone or increases in poverty solely to subsidy cuts.

The empirical evidence on changes in the level of poverty and inequality in the post-1977 period has generated an extensive literature, but one which is mainly confined to the analysis of distributional changes within the whole community. There is little or no rigorous analysis of the ethnic dimensions of those changes, partly due to quite serious data problems, and there are two main, and divergent, views on the changes. Bhalla and Glewwe have argued that the period after 1977 was marked not only by an acceleration of economic growth but also by a reduction

in income inequality (Bhalla and Glewwe 1986; Glewwe 1986, 1988a, 1988b). They attribute both of these results to the beneficial effects of liberalization.

In our view, however, the methodological criticisms of their critics (Anand and Kanbur 1991; Divisekara and Flemingham 1986; Lakshman 1986; Ravallion and Jayasuriya 1988; Sahn 1985) are persuasive and indicate a deepening of inequality, with particularly adverse effects on the lowest income households. This view is supported by data from the Consumer Finance Survey of 1986–87, which became available only recently. According to Edirisinghe (1991a), figures provided by the Central Bank suggest a considerable worsening of poverty between 1978–79 and 1986–87, with the proportion of households living in absolute poverty increasing from 19 to 27 percent during this period. As we have argued earlier, even the growth effects of the immediate post-1977 period owed more to the public investment surge than to the positive effects of liberalization.

The growth of average income during this period appears to have masked pronounced distributional changes. Anand and Kanbur (1991:79), in a critique of the Bhalla/Glewwe analyses, point out that, between 1978–79 and 1981–82,

with the rupees 60 (per capita monthly food expenditure in 1978–79 prices) poverty line, the incidence of poverty in Sri Lanka goes up from 12.9 percent to 13.3 percent. This increase is driven largely by an increase in the incidence of poverty in the rural sector from 12.8 percent to 13.6 percent. A small positive contribution is also made by the rise in estate sector incidence from 3.6 percent to 5.8 percent, but this is more than counteracted by a fall in urban poverty incidence from 14.3 percent to 12.4 percent.

The direct cause of this increase in rural poverty is not obvious (particularly in view of the significant increase in rice production), but an important factor is likely to have been the reduction in food subsidies. It is probable that even the rural poor were adversely affected by higher food prices induced by subsidy cuts; they were net consumers of food, and their incomes did not rise sufficiently to compensate for higher food expenditures. The cuts in food subsidies were drastic. Real government expenditure on them fell by 69 percent between 1979 and 1982, after rising in the 1977–79 period (Ravallion and Jayasuriya 1988). The negative impact of the 1977 subsidy cuts on the poor is also shown by data on daily calorie intake reported by Sahn (1985). The percentage of Sri Lankans with intake below 1,800 calories per day rose from 12.6 to 15.5 percent.

The impact of the first real devaluation would have benefited those in the tradable sectors, including rural producers of agricultural exportables and those who were able to obtain employment in the expanding tradable manufacturing industries. But these positive effects were counteracted by the (exogenous) fall in the world prices of some key export crops. The erosion of the real depreciation rate over time would also have reduced the initial positive effects.

The effects of trade liberalization and capital market reform on overall income distribution cannot be directly ascertained from the available data. But there

are no compelling reasons to expect that more complete data would show a general worsening of absolute poverty, even though the sectoral patterns of income distribution would have changed. In fact, the trade liberalization patterns that ended shortages of many consumer goods and reduced their effective prices were extremely popular among all classes. This is not surprising, given that a large proportion of wage goods are imported. Even if the prices of certain imported goods rose, overall consumer welfare probably increased as a result of greater availability.³¹ Similarly, in principle, both net savers and net borrowers gained from capital market liberalization. Savers gained from earlier higher returns on savings, while borrowers gained from easier access to credit.

Unlike the food subsidy reduction, however, trade liberalization could have had a differential impact on ethnic and regional patterns of income distribution. Some of the losers from trade liberalization were the farmers who had benefited from the import restrictions that had once raised the prices of certain food crops, such as chilies and onions. Since these crops are well-suited to the northern parts of the country, Tamil farmers in the Jaffna peninsula became major producers of these crops during the protectionist period and suffered from falling prices after trade liberalization occurred. This generalization does not apply to the entire Tamil community, however. Tamil consumers gained from lower prices and greater availability of imports, and from the general revival of private sector commercial and trade activities, where members of the Tamil community had traditionally played an important role. Further, there was a large exodus of skilled Tamil workers (as part of the general emigration) to jobs in the Middle East in the late 1970s that was facilitated by some aspects of the broader liberalization package. Unfortunately, there exist no data on levels of income (or expenditure) in the immediate preliberalization period that could be compared with the data for the immediate postliberalization period. The overall effects of liberalization on the relative incomes of the Tamil community are unclear, but there is no strong evidence to suggest that they were generally adverse.

The more direct and important economic effects with a bearing on ethnic and regional income differences were probably related to the nature of the public sector investment program and the decisions made on the distribution of transfers. The government's concentration on the Mahaweli project was perceived by the Tamil community as discriminatory. The Tamils saw the project as predominantly benefiting the Sinhalese community, and this perception was not entirely unfounded. During the planning of the Mahaweli project, the Tamil community had asked that the project's irrigation benefits be extended to traditional Tamil settlements, but these requests had been rejected.

Ever since the 1930s, in fact, the Tamil community had objected to state-funded settlement schemes to resettle landless Sinhalese in the sparsely populated parts of the dry zone. These "colonization" schemes typically involved the rehabilitation of ancient irrigation systems or construction of new ones, and were often inefficient. But the policymakers had other goals. The goal of rice self-sufficiency was one. There was also an overtly ethnic objective. The new settlers came mostly

from the southern part of the country and were ethnically Sinhalese. The Mahaweli plan was proclaimed by leading Sinhalese politicians to be aimed at recreating the ancient glories of the Sinhalese kingdom in the dry zone.

The large investment in the public sector also meant that a large proportion of new employment was being created in that sector, but Tamils encountered two obstacles in obtaining public sector jobs. One was the imposition of proficiency requirements in Sinhalese for public sector employment, and the other was the marginalization of the Tamil community from the mainstream political process. This made it difficult for Tamils to obtain the political patronage that had become increasingly more important for obtaining such employment. The imposition of racial quotas in higher education institutions compounded these problems. Traditionally, Tamils had invested heavily in education and were particularly well-represented in the technical and professional sectors. Racial quotas blocked these avenues of advancement for Tamil youth.

The initial employment growth caused by the PSIP gradually slackened as projects neared completion. On the other hand, the real exchange rate effects of those programs tended to discourage the growth of labor-intensive export-oriented industries that could have provided a more stable long-term source of employment and income growth. The choices made in relation to the allocation of transfers made the distributional outcomes worse.

We have already referred to the food subsidy cuts and their probable distributional effects. The strongest economic rationale for this policy was the argument that the subsidies constituted a fiscal burden large enough to threaten macroeconomic stability. If the subsidy cuts were aimed at freeing up the financing needed for productive investments that would alleviate future poverty, then in principle the cuts could be considered a trade-off between present and future poverty alleviation. But if the funds made available by the subsidy cuts were directly or indirectly used to finance programs that did not reduce future poverty, the trade-off was a different one.

The government followed the latter path. Massive transfers were made to politically favored but loss-making public enterprises whose losses substantially offset the impact of subsidy cuts on fiscal deficits. A particularly glaring example of these inequitable transfers involved the national airline, Air Lanka. During the 1980s, annual transfers to Air Lanka approached (and sometimes exceeded) the expenditures on food subsidies. The airline consistently obtained transfers larger than the combined total that went to the public bus and railway systems. Since the country was well-served by international airlines, there were no economic arguments to even remotely justify these subsidies. In a country as politically sensitive as Sri Lanka to consumer welfare changes, the political consequences of such choices would have been easy to predict.

As the above discussion shows, the long-term growth consequences of the macroeconomic policies of the post-1977 period have to be related to the entire package of policies implemented during this period. The consequences of those

other policies often conflicted with the stated goals and objectives of the reform package and reduced their effectiveness.

Initially, these conflicts appeared not to matter, but as macroeconomic imbalances emerged with the inflationary surge in 1980, the need for possibly painful adjustment measures became clear. However, there were political constraints. The initial popular euphoria gave way to disillusionment with the government, particularly as inflation eroded the value of food stamps and exposed the reality of food subsidy cuts. The decline of popular support was seen in the election in 1982, which touched off widespread allegations of electoral fraud (Manor 1984). Under such clouded circumstances, a government in a democracy finds it difficult to implement painful adjustment measures.

In these circumstances, there was pressure to resort to the traditional options of trade and exchange rate controls. This temptation was generally resisted, partly because of pressure from donor agencies but also because this approach would have been highly unpopular in the country itself. On the other hand, choices made about government transfers during this period did little to correct either macroeconomic imbalances or income distribution. To the extent that they aggravated social tensions, disrupted production and investment, and raised defense expenditures, the transfers did considerable damage to long-term growth.

Chapter Seven

Summary and Conclusions

When Sri Lanka became independent in 1948 it appeared to have all the characteristics needed for rapid and sustained economic growth. It had what appeared to be a stable political system based on parliamentary democracy, and it had a high standard of living by developing country standards. In terms of income, literacy, and health care it was well ahead of most of its neighbors, and Sri Lankan society was not characterized by extremes of poverty and wealth. But violent social and political conflict in the 1980s shattered the country's outlook, and as the 1990s began the prospect that the Sri Lankan economy would enter a sustained growth path in the near future appeared slim.

Terms of Trade Fluctuations and Optimal Policy

As a primary commodity exporter, Sri Lanka has periodically faced sharp swings in its terms of trade, and rational macroeconomic policymaking would have been rooted in this reality. If an intertemporal consumption-smoothing strategy was considered optimal, then it was necessary to build up external reserves during good times by running current account surpluses so that deficits could be financed in bad times. Otherwise, the periodic swings in the terms of trade would generate a pattern of boom and bust, and if domestic absorption was downward rigid, regular and ever more serious balance of payments crises were inevitable. If both private agents and the government were well-informed and rational, their savings and investment decisions would have been based on this reality, and the current account outcomes would have reflected it. However, as our analysis has shown, the actual history of Sri Lanka was quite different, and one of our objectives is to explain why this was so.

Certainly, neither the government nor private agents could have fully anticipated the long secular decline in the real prices of Sri Lanka's traditional export

crops in the early postwar years. But this can be at most only part of the explanation. Even by the late 1950s there was a general recognition that the real prices of those commodities were unlikely to rise in the long run. Indeed, the rationale for pursuing industrialization and agricultural diversification was that primary commodity prices would decline in the long run.

It was also not the case that trends in the world economy were unfavorable. Opportunities for expansion of labor-intensive manufactures were at hand, and there were clear possibilities for export growth and efficient diversification. These might well have counteracted the declining trend in terms of trade implied by continued reliance on traditional export crops alone. In other words, recurrent balance of payments crises due to periodic terms of trade swings or long-term backsliding due to adverse price movements were not inevitable. The reasons for the long-term problems have to be sought elsewhere, by examining the levels and patterns of savings and investment, the efficiency of investment, and how economic policies influenced savings and investment.

Welfare Expenditures: Not the Key Issue

The issue of growth versus equity has figured prominently in recent debates on Sri Lanka's economic performance. This has been seen primarily in terms of a tradeoff between allocating resources to consumer subsidies or allocating them to investment. The achievements of Sri Lanka in the areas of health, education, and income have justly received wide acclaim and are considered to demonstrate the successes that can be achieved with targeted government intervention. However, high levels of expenditures on welfare are unsustainable without growth. If funds allocated to these programs are redirected to productive investment, growth and future incomes can be raised, and in that sense there is a clear tradeoff between current expenditures on welfare and the levels of future incomes. To the extent that economic growth is expected to reduce poverty, this raises issues of intertemporal and intergenerational tradeoffs.³²

We have discussed the fiscal constraints imposed by welfare expenditures and their macroeconomic consequences, pointing out the link between fiscal deficits and balance of payments problems. Note, however, that the size of fiscal deficits could have been reduced without incurring major welfare losses. Given that consumer subsidies were provided for the whole population and not just the poor, there can be little doubt that welfare expenditures could have been better targeted and the alleviation of poverty achieved at lower cost. Further, other government expenditures, including certain capital expenditures, were quite inefficient.

Note also the choice of instruments which were used to raise government revenues to finance welfare expenditures. In the main, revenues were raised by highly distortionary taxes on trade that exacerbated the adverse impact of overall government policies on traditional exports.

Thus, the focus on welfare expenditures as the sole, or even the main, constraint to growth grossly oversimplifies the role of the broader economic policies followed by the government.

The most striking feature of Sri Lankan macroeconomic history in the postindependence period was the reluctance to address basic macroeconomic imbalances at their source and to adopt a long-term perspective in policymaking. A tendency to treat temporary favorable conditions as if they were permanent is a common thread of continuity through all the regime and policy changes. Perfect foresight was not needed, for example, to have realized that the commodity price boom during the Korean War, or the periodic tea price booms caused by weather-induced world supply shortages, would not be permanent. But time and again, driven by short-term political goals, Sri Lankan governments behaved as if these were indeed permanent. Current expenditures were raised during such times, but they could not be cut in bad times due to the downward rigidity of the social wage, a product of the political polarization of society and the strength of Sri Lankan trade unions. Locked into levels of expenditure that were unsustainable in the long run without rapid growth, and facing chronic fiscal and current account deficits, successive governments resorted to increasingly tighter trade, exchange rate, and other capital market restrictions to achieve temporary external balance.

Macroeconomic Imbalances, and Trade and Exchange Rate Controls

The consequences of a long-term policy of ever-increasing reliance on trade and exchange controls to address (or, rather, to avoid addressing) macroeconomic imbalances are clear. Patterns of investment become distorted, bureaucratic regulations become pervasive, growth slows down, and, despite its quantitatively reduced dependence on imports, the economy finally ends up in a state of extreme vulnerability to external shocks. These problems are compounded by policies of financial repression that lead to low domestic savings and higher reliance on foreign savings. Private agents are unable to generate stabilizing responses to changing external conditions because price signals are heavily distorted and regulations severely constrain the range of available options. In such circumstances, private and social profitability diverge more and more, and the productivity of investment declines.

The role of economic nationalist ideology in the Sri Lankan context was to rationalize and justify long-term reliance on trade and exchange controls. The ideology was based on a worldview that ignored the evolution of the Sri Lankan economy and thus propagated the myth that Sri Lanka could develop in isolation from the powerful forces molding the world economy. This view, untenable even for large economies, was completely at variance with reality for a small trade-dependent economy like Sri Lanka's. While the initial imposition of controls was dictated by pragmatic, short-term balance of payments considerations, vested in-

terests gained from the continuation of controls and reinforced the ideology of economic nationalism. But adjustments to crisis situations that aggravated the inward orientation of the economy were doomed to lead to economic stagnation and failure. This lesson was driven home by the longer-term failure of the crisis management measures adopted during the 1973–75 crisis, although these measures made it possible to avoid an immediate inflationary crisis or a large buildup of external debt.

Change and Continuity in the Post-1977 Period

We have examined post-1977 Sri Lankan experience in light of the lessons of the preceding period of economic stagnation. The changes since 1977 have been widely accepted as representing a major break with previous policies, and certainly there have been important changes. The very acceptance of the idea that inward-oriented policies had reached an impasse was a major break with the past, and the trade and exchange rate reforms were extensive and far-reaching. However, the new regime's basic strategy was centered on the "big push" of a public sector investment surge to achieve self-sufficiency in food. This strategy reflected the political pressure for higher incomes and employment in a short period of time, and in the short run both could be achieved with a large public sector investment program. The rapid economic growth achieved in the early years created a euphoric optimism aroused by the massive capital flows accompanying the policy reforms. Initial reductions in welfare expenditures were made under conditions of rapid growth and a broad-based rise in income, and there was little effective resistance to the cuts. Inefficient enterprises in the public sector were made conduits for employment generation and political patronage, a continuation of past practice, and they were maintained by large fiscal transfers and regulations that insulated them from the impact of trade liberalization. It seemed as if a painless transition to a rapidly growing free market economy was becoming a reality.

But this was a misleading picture. The rapid growth recorded in the early period primarily reflected the direct, short-term impact of the massive fiscal stimulus to the economy and was essentially a Keynesian-type demand-determined growth. Whether such growth could be sustained in the longer run depended on the productivity of the investments and the successes of the policy reforms, but the very nature of the surge undermined the potential for enhancing investment efficiency.

Large Projects, Macroeconomic Stability, and Growth

Here, it is useful to summarize the lessons learned from the public sector investment program built around the two lead projects, the Mahaweli scheme and the

housing program. The capital devoted to these two projects dwarfed all other investments. Recall that at its peak, the Mahaweli project alone absorbed six percent of GDP, 17 percent of total government expenditure, and 44 percent of all government capital expenditure. Economic and political developments during the planning and implementation of these projects make it possible to formulate the following generalizations:

- Strategies that create boom conditions overnight appeal to politicians and donor agencies.
- Implementation of large projects has immediate positive effects on overall growth indicators, irrespective of their longer-term impact. (In much the same way, pyramid-building would have dramatically raised the growth rate in the construction and services sectors and therefore of overall GDP in ancient Egypt!)
- Impressive growth indicators suggest a vibrant economy and help attract, for a time, greater economic and political support both at home and abroad.
- The success or failure of such projects comes to be seen as an indicator of the success or failure of the regime (not to mention donors). Objective appraisals are ignored, and changes become difficult to implement. The temptation to throw good money after bad becomes almost irresistible, due to political imperatives.
- Such investments crowd out other, more socially beneficial but less glamorous investments. Further, by their overall impact on the wider economy they distort the pattern of private investment.
- To the extent that benefits from these projects are not widely diffused, they may aggravate internal social tensions.
- Such projects reduce the government's ability to respond flexibly to shocks by making it impossible to undertake expenditure reductions.
- Other sectors then bear the brunt of the necessary cuts.
- Such projects can have large and potentially adverse impacts on macroeconomic stability and sectoral performance that run counter to the long-term interests of the economy. Indeed, in the Sri Lankan case, the public investment program, by appreciating the real exchange rate, counteracted the structural adjustment goals of trade and exchange rate liberalization, which required a real depreciation.

Sri Lanka's Experience in a Comparative Setting

The history of Sri Lanka during the latter half of the 1980s suggests that the problems that have plagued the economy since independence remain unresolved. Export growth has remained sluggish, domestic savings remain low, and balance of payments pressures have not ceased. Given that many other small developing

economies also were confronted by major shocks during this period, it is useful to briefly compare Sri Lanka's performance with that of similar countries to place it in perspective.

The adoption of trade restrictions in response to balance of payments crises was not unique to Sri Lanka; it was a common practice among developing countries until the 1970s. And as in Sri Lanka, these restrictions have often tended to perpetuate themselves. The consequences, too, have been similar. What distinguishes Sri Lanka from other countries was the pervasiveness and stringency of the restrictions, particularly during the early 1970s. Perhaps the only comparable Asian country (outside the centrally planned countries) was Burma under the Ne Win regime.

But in response to the 1973–75 crisis, Sri Lanka's actions differed from those of most developing countries in that its fiscal policy was strongly deflationary and its crisis-induced rate of inflation was moderate by most developing country standards. Moreover, and unlike many developing countries, Sri Lanka passed through the 1973–75 crisis without incurring a large external debt. All of this, however, was achieved at a high cost in terms of investment and growth.

Sri Lanka's post-1977 development had many similarities with public sector spending booms during the mid-1970s in a number of developing countries, such as Indonesia, Nigeria, Pakistan, and Turkey (see Corden 1991 for a detailed discussion). In most such cases, however, the surge in spending was related to an export boom of some sort (oil in Indonesia and Nigeria) or to the availability of migrant worker remittances and cheap credit (Pakistan and Turkey). Although Sri Lanka also benefited from migrant worker remittances, the main source of external funding was aid.

In terms of the magnitude of the rise in public spending, Sri Lanka towered above all others. No other country in recent history raised public sector spending so massively in such a short period of time. But its boom ended the same way as many of the others: faltering growth after an initial jump, accompanied by balance of payments and debt problems. Perhaps the worst aspect of such booms (and one shared by Sri Lanka) was that they made it possible to postpone necessary adjustments at the cost of even more severe problems later.

Conclusions

Up until the ethnic upheaval of the 1980s, Sri Lanka's extensive array of welfare subsidies facilitated social peace and contributed to political stability. But despite their effectiveness, such policies were unsustainable without economic growth, which required policies based on a long-term perspective and devoted to exploiting the trade opportunities offered by the international economy. Thus, Sri Lanka missed the chance for greater growth offered by the widespread postwar boom.

A comparable era of sustained worldwide economic growth is not on the horizon. The 1990s promise to be a period of great volatility in the world economy. The decade started badly for Sri Lanka as the Gulf War added to the burdens of the ongoing civil war by destroying two major sources of external finance: Iraq was a large buyer of Sri Lankan tea, and the Middle East was the largest source of employment for Sri Lanka's migrant workers. While political stability appeared to be a possibility after the crushing of the JVP uprising in 1989–90, and some important policy initiatives were undertaken, tensions continued to simmer beneath the surface.

Thus, the country's economic prospects will depend to a large degree on political developments that are difficult to predict. But the depths of Sri Lanka's long crises can only be removed by fundamental change. Long-term growth must be based on policies that stimulate savings and raise investment efficiency, allow flexible responses to domestic and external circumstances, and recognize that the Sri Lankan economy is closely tied to the world economy. Only such policies will achieve economic growth and poverty alleviation over the long term and thus permanently resolve the country's ingrained social and ethnic conflicts. Developing such policies is the challenge facing Sri Lanka today.

Appendix I

In the orthodox neoclassical growth model (Solow 1956; Swan 1956; Meade 1961; Uzawa 1961) the long-run growth rate depends on the growth rate of the labor force and the exogenously given rate of technological change. Changes in the rate of investment, according to the model, have no long-run effects on growth. Technological change is assumed to be independent of the rate of investment, which implies that any change in the latter can have only transitory effects. Variations on this model, such as the vintage model in which technical change is embodied in investment, do not alter this basic conclusion (for an exposition and comparison of these models, see Hamberg 1971). Development economists have been uncomfortable with these models. While prescribing all manner of policy packages that were supposed to make a real difference in the long run, the models attach no importance to policy.

Note, however, that, even in the traditional model, investment does change the growth rate, except in the long run. Attempts to develop theoretical foundations for models in which policy affects long-run steady-state growth have led to a large and growing body of theoretical literature (see, for example, Barro 1991; Grossman and Helpman 1989; King and Rebelo 1990; Lucas 1988; Rebelo 1991; Romer 1986). A major contribution to this literature has been that of Scott (1989), who has produced a fundamental critique of the traditional neoclassical growth model and the methodology of the empirical studies used to support that model. He argues that the level and quality of investment are crucial determinants of the long-run growth rate, and that investment is better regarded as the cost, in terms of consumption foregone, of changing economic circumstances than as physical increments to the capital stock. Technical progress, so the argument goes, is not independent of investment, and new capital seldom reduplicates old capital. (Some of the best-known empirical studies, such as Denison (1967), treat investment as if new capital merely reduplicates existing assets.) The rate of invention is "endogenized" in the rate of gross investment rather than treated as exogenous. Technical change is not unimportant; rather, it cannot be separated from measures of new investment.

In the Scott model the growth rate is explained by two main variables, the growth of employment and the rate of investment. The capital stock is not of central interest, and there is no independent rate of technological progress variable. Thus, the basic Scott growth equation is:

$$G = aQS + bL \quad (1)$$

where,

G	=	rate of growth of output
Q	=	investment efficiency
S	=	rate of investment
L	=	rate of growth of employment

and a and b are country specific parameters.

The variable Q allows for such factors as diminishing returns to the rate of investment. Thus, as S increases, investment efficiency can decline, since fewer and fewer productive investment projects will be included in the total investment program. Other relevant variables are those that may influence the quality or efficiency of investment, such as the tax system, capital market efficiency, and the pressure of competition. (In principle, variables that affect the quality of labor also enter into the equation.) We can express these relationships affecting investment efficiency in terms of the following equation:

$$Q = Q(S, T) = (1 + a^1S + a^2T) \quad (2)$$

The first term in equation 2 can be allowed for by adding the term S_2 to the right-hand side of equation 1. The expected sign for the coefficient of this variable is negative. The term T is an index of the degree of trade liberalization (see Cuthbertson and Athukorala 1990). We hypothesize that trade liberalization is likely to improve allocative efficiency in the economy and thereby impact on investment efficiency. T is entered as an interactive term for S (that is, $T*S$) whose coefficient is expected to be positive.

We adapted this hypothesis in examining the Sri Lankan growth pattern and estimated the following equation:

$$G = aS + bS^2 + c(T*S) + L + U + D_1 + D_2 \quad (3)$$

Following Scott, the G variable refers to the rate of growth of real output in the nonresidential business sector. Gross investment is conventionally defined as the measure of material investment net of maintenance. The rate of investment is simply the gross investment to GDP ratio, estimated using both series (in current prices). To allow for the gestation of investment, we use the moving averages of the investment rate over three previous years. Rate of growth of employment (L) should, in principle, be measured using "quality adjusted" employment data. In the absence of this ideal measure, we measured employment growth in terms of gross employment. It should be noted that our employment series is of doubtful quality even as an indicator of change in gross employment. When equation 1 is estimated using time series data, rather than fairly long period averages, it is important to allow for cyclical fluctuations in growth. We use U , an index of capacity utilization, as an additional regressor to allow for that. In the absence of a better

alternative, the series for U was constructed as the ratio of actual output to trend output obtained by fitting an exponential trend line.

We also include three dummy variables to incorporate the effects of the 1971 events, major changes in the economic and political environment after the 1950s, and the impact of the civil war during the 1987–89 period (the variables having a value of 1 during the relevant period and 0 otherwise).

The model was first estimated with data for 1950–79, since the data series for L was available only for this period. L was subsequently dropped and the equation was re-estimated, since its coefficient was consistently statistically insignificant and had an unexpected (negative) sign. The lack of significance of this variable may be due to the very poor quality of the employment data series (see the statistical appendix) and in any case does not fully capture the changes in underemployment that are important in labor-surplus economies like Sri Lanka's. Further, note that we could not adjust it for quality due to lack of a suitable measure. The deletion of this variable enabled us to use a longer time series, and the final equation was estimated for the period 1950 to 1983. The sample period could not be extended beyond 1983 because of an inexplicable inconsistency in the subsequently available investment series. The equation was estimated using TSLS; there was evidence, in terms of the Wu-Hausman test, that S is asymptotically correlated with the contemporaneous disturbance term. The results are reported in table 6.1, and the data series are given in table SA-19.

The equation explains nearly 70 percent of the variation in the annual rate of growth of real GDP over the sample period. This is quite a satisfactory fit given the absence of the employment variable, the quality of the data, and (in particular) the absence of a direct measure of capacity utilization to satisfactorily account for cyclical influences on output.¹

Determinants of Domestic Savings

The following regression models were tested, using annual data for the period 1960–87.

Total domestic savings (DS) and domestic private savings (DPS):

$$DS \text{ or } DPS = f(YR, PGDP, RSTD, D*RSTD, FS, FIR, D)$$

Domestic financial savings (FNS):

$$FNS = f(PGDP, RSTD, D*RSTD, PE, D*PE, D)$$

The explanatory variables (with expected signs of the regression coefficient in parentheses) are:

$YR (+)$ = growth rate of GDP (1980 prices) measured as logarithmic differences

<i>PGDP</i> (+)	= per capita GDP (1980 price) in logs
<i>RSTD</i> (+)	= weighted average real interest rate on savings and time deposits
<i>PE</i> (-1)	= expected rate of inflation proxied by the rate of inflation with a one-year lag
<i>FS</i> (-)	= foreign savings (1980 price) in million rupees
<i>FIR</i> (+)	= financial intermediation ratio, measured as the ratio of M3 to GDP
<i>D</i>	= a dummy variable which takes value 1 for years 1978 through 1987 (post-trade liberalization period) and 0 for other years

Domestic saving (*DS*) is estimated by subtracting foreign saving (*FS*) from gross domestic investment. Foreign saving is taken as equivalent to the balance of payments deficit on the current account. Private saving (*PS*) is estimated by subtracting budgetary saving (*GB*) from *DS*. Budgetary saving is defined as the excess of government revenue over government current expenditure plus capital outlays for military hardware. Gross (rather than net) saving is used because of the unavailability of data on depreciation allowances.

A major limitation in estimating domestic saving by subtracting foreign saving from *GDI* is that inaccuracies in either series may lead to measurement errors. However, if the biases are consistent over time and errors are random, the use of this series need not necessarily yield misleading results (Fry 1988).

In studies of savings behavior in developing countries, private and public savings have usually been treated as a lump-sum variable. Aggregating these two components, however, can bias the coefficient of the savings function because the underlying determinants of the two tend to be different. In particular, public savings usually exhibit a higher degree of volatility than private savings. To allow for these differences, we estimated a function for domestic private savings in addition to the one for total domestic savings.

A separate function for financial savings is estimated as a way of shedding light on the implications of interest rate policy for the mobilization of private savings. Financial savings are proxied here by annual changes in time and savings deposits in commercial banks and other noncontractual saving institutions (that is, the change in $M3 - M1$).

Dummy variables (slope dummies for the interest rate and inflationary expectation variables, and the intercept dummy, *D*) are included to capture the impact on observed relationships of changes in broad government policies and possible shifts in private sector factors brought about by the financial market and trade liberalization policy package introduced in late 1977.

The other variables are those commonly used to capture the essence of the major hypotheses advanced to explain savings in developing countries.² The growth rate variable (*YR*) is justified on the ground that rapid growth leads to increased transitory income in relation to permanent income, and the former influences saving more than the latter. The per capita GDP variable (*PGDP*) reflects the

state of development in the economy, which has a direct bearing on the level of savings. Foreign savings (FS) is included to test the hypothesis that such inflows may "crowd out" domestic savings by allowing the government and residents to consume more at a given rate of capital accumulation (Weisskopf 1972; Newlyn 1977). This variable is included linearly (in million rupees) rather than in log form because it assumes negative values in some years in the sample period. The financial intermediation ratio (FIR) is included to capture the impact of changes in the degree of financial deepening on domestic savings mobilization. Financial deepening helps raise the domestic savings rate by raising the level of financial savings and by improving the efficiency with which loanable funds are allocated.³

The results of the regression exercise are reported in Table 6.1 in the text. Note that the intercept dummy, D, was excluded from the final equations. In experimental runs the high multicollinearity between it, PGDP, and the slope dummies resulted in distorted coefficient estimates. Preliminary estimates using OLS indicated the presence of significant autocorrelation among residuals in the total domestic savings and domestic private savings functions. Therefore, an iterative maximum likelihood correction procedure was adopted.

Determinants of Private Investment

The model estimated to explain private investment behavior is the following:

$$PRIV = f(ICP, YR, RC, PBIV(-I), PRIV(-I))$$

where PRIV is real private sector fixed capital formation. The explanatory variables (with the expected signs of the regression coefficients in parentheses) are:

- ICP* (+) = total real institutional credit to the private sector in log
- YR* (+) = growth rate of real GDP estimated in terms of log differences
- PBIV* (><0) = real public sector fixed investment in log, lagged year
- RC* = an index (1980 = 1) of rental cost of capital (to be explained below).

All variables are measured at 1980 prices. The index of rental cost of capital (RC) is constructed as:

$$RC = PIM * (I + NLR)/P$$

where

- PIM* = price of investment goods proxied by the import price index of investment goods (1980=100) adjusted for the

dual exchange rate (FEEC) premium for the period
1968–77

NLR = nominal one-year (maximum) lending rate of commercial
banks

P = implicit GDP deflator (1980 = 100) for nonservice activities.

The cost of capital depreciation was ignored because of lack of data. The inclusion of GDP growth (YR) as an explanatory variable implies an accelerator-type relationship between the level of domestic economic activity and capital formation. A view that has gained considerable currency is that one of the principal constraints on investment in developing countries is the quantity of available financial resources rather than their cost. The rudimentary nature of the capital market in these countries limits the financing of private investment to retained profits and bank credits. Of these, the flow of bank credit is perhaps the most important. We therefore include the annual change in real credit (ICP) as an explanatory variable. PBIV was chosen as an explanatory variable in the light of the debate on the crowding out effect (Blejer and Khan 1984). PRIV(-1) is included as a regressor on grounds that the adjustment of actual investment to the desired level is not completed within a single period.

The model was estimated by OLS using annual data covering the period 1960–82.⁴ The results are reported in table 6.2.

Short-Run Supply Response of Exports

In this section we report on an analysis of the response of Sri Lankan commodity exports to economic incentives. Given the heterogeneity of exports and the selectivity with which export-incentive (disincentive) policies were implemented, results obtained for total exports (or even for the two conventionally identified categories: traditional and nontraditional exports) might be of little policy relevance. In this exercise we therefore treated exports under eight subcategories. The sample period was 1965–85.

Methodology

The export supply equation was of the form:

RX = f (REER, LPRD or TIME, LBD)
RX = real exports
REER = real effective exchange rates
LPRD = production lagged by one year
TIME = time trend (1965 = 0)

LBD = a dummy variable set equal to 1 for the years 1978–85 and 0 otherwise.

All regression coefficients were expected to be positive. For tea, rubber, and coconut kernel products (henceforth coconut for short), the Central Bank's export volume indexes were employed as the dependent variable (RX). For other commodity categories other than gems, the RX series was constructed by deflating export earnings by the respective export price (unit value) indexes. Due to the lack of an appropriate price index, the dependent variable for gems is measured in units of a million dollars each.

$REER$, the key explanatory variable in the model, measures changes over time in the relative profitability of exporting and selling domestically. It brings together changes in the nominal exchange rate, the effective value of financial incentives, and domestic and world market (foreign currency) prices. It is defined as:

$$REER = \frac{[OER (1 - TX + SX)] PW}{PD}$$

where

OER = official exchange rate (Sri Lanka rupees per one U.S. dollar)
 TX = export tax rate
 SX = rate of total effective subsidy
 PD = index of domestic prices
 PW = index of foreign (export) prices.

The numerator of the above formula is simply the index of the local currency price of exports (LCPX). $REER$, which is measured as the ratio of LCPX to domestic price index (PD), is therefore a composite indicator of relative export profitability. The U.S. dollar is the principal invoicing currency in foreign trade for Sri Lanka, accounting for over 60 percent of total export receipts. Ideally, the rate should have been deflated by an index of composite value of all currencies used in export transactions to take into account fluctuations in exchange value of these currencies compared with the dollar. This was not possible because of lack of sufficient data. Normally, the composite index is compiled using the share of each partner country in total exports as the proxy weight. We did not adopt this procedure because it would have resulted in a misleading indication of the average exchange rate change, since trade with any particular country is not conducted exclusively in the currency of that country.

The subsidy rate (SX) incorporates import duty rebates, rebates on the turnover tax, the subsidy equivalent of export credit and outright cash grants, and the scarcity premium of credit to convertible rupee accounts (for the period 1973–77). Tax concessions at the income tax level were not taken into account because of identification difficulties.

For all commodity categories, the foreign-price index (PW) used was the export unit value index adjusted for exchange rate changes. For tea, rubber, and co-

conut, the cost of production index was used as the domestic price variable. Domestic price indexes used for the other commodity categories were the implicit national product deflator for nonplantation agriculture (all minor agricultural exports and spices), the implicit national product deflator of manufacturing (for total manufactures and other manufactures), and the GDP deflator (for coconut by-products and gems).

The REER variable is expected to capture only the changes in real exports resulting from movement along the production possibility curve triggered by relative price changes. In practice, even if REER remains unchanged, exports would still change depending on shifts in the country's production capacity. The net effect of changes in the REER on exports can therefore be meaningfully delineated only if the latter changes are taken into account. On these grounds, we used two alternative proxies to account for shifts in the production possibility curve: production lagged one year (LPRD) in the three manufactured goods equations, and time trend (TIME) in the other equations.

The third explanatory variable, LBD, is included to capture the distinction (if any) between the pre- and post-trade liberalization periods with regard to export performance. The existing literature suggests that the favorable impact of trade liberalization on export performance is not limited to relative price aspects (which are captured in the REER). Various institutional changes embodied in a liberalization package (such as easy access to imported inputs, increased flexibility in the exchange control mechanism, and a more conducive atmosphere for private sector activity) may also contribute to improved export performance (Bhagwati 1978; Krueger 1978).

An important assumption implicit in the model is that foreign demand for Sri Lankan exports is perfectly price-elastic, which implies that export prices are determined exogenously (the "small-country" assumption). Judging from market share data, this assumption seems justified for all commodity categories except tea. Yet even for tea, Sri Lanka's market share has been declining (27 percent in 1980–83 as against 32 percent in 1972–74).

A short-run export supply model of this nature has limited relevance for perennial crops, which are characterized by a high degree of inflexibility in the short run.⁵ However, output of these products can be varied by varying the harvesting intensity (that is, intensive tapping in the case of rubber, intensive plucking in the case of tea) and to a certain extent by varying the application of inputs, such as fertilizer and other yield stimulants. Moreover, in cases where a significant portion of output is absorbed locally, export volume can be varied through changes in the rate of local absorption.

Regression Results

The regression equation estimated for the selected commodity categories using ordinary least squares was reported in table SA-1. All the equations have been corrected for autocorrelation using the maximum likelihood iterative technique

(ARI). The model was estimated in both linear and log-linear forms. While broadly similar results were obtained with both forms, the log linear form generally provided a better fit. The coefficient of REER in each regression can therefore be directly interpreted as an estimate of the export supply elasticity. Note that in all regressions REER has been included with a one-year lag. This specification generally gave better results than when current period REER was included. Alternative specifications with higher-order lags, as well as a partial adjustment specification (that is, the inclusion of lagged dependent variables as an explicator), failed to yield better results.

The coefficient for REER in the equation for rubber is statistically insignificant, but is statistically significant for tea and coconut. The estimated export supply elasticities for these two commodities are 0.3 and 0.7, respectively. The results generally support the view that Sri Lanka's traditional exports are price inelastic in the short-run. However, the weak year-to-year link between REER and real exports does not mean much with regard to the implications of the incentive structure for long-term export performance.

The relatively higher elasticity estimate for coconut is not surprising because, in contrast to tea and rubber (of which less than 10 percent is absorbed locally), nearly 75 percent of total coconut production is consumed locally. Therefore, the level of domestic demand is a very important determinant of export levels. Throughout the period under study, coconut output expanded at a slower rate than the rate of expansion in local demand. This helped generate a highly lucrative domestic market, thereby reducing the exportable surplus.

As regards minor agricultural products, the coefficient of REER is not significantly different from zero in the equations for the aggregate as well as for coconut by-products and spices. The coefficient of REER in the equation for the residual minor agricultural commodity category (2.3) is significant and has the expected sign. The estimate suggests that a one percent change in relative price is reflected in a 1.2 percent change in real exports with a one-year lag. This commodity group contains a variety of products, ranging from crops with a long gestation period (such as cocoa and coffee) to crops with a shorter gestation period, such as cut-flowers and vegetables. The high elasticity coefficient reported above is probably strongly influenced by the export behavior of products in the latter category, which have shown considerable dynamism since the early 1970s.

Gem exports (category 3) appear to be as highly elastic (2.6) with respect to changes in incentives. A well-known feature of the Sri Lankan gem trade is that a significant portion of total exports occurs through illicit channels. Therefore, exporters can respond to changes in export incentives simply by shifting exports from illicit channels to official channels. This makes official exports quite sensitive to incentive changes.

The coefficient of REER in the equation for total manufactured exports is not statistically significant. The estimates for the two manufacturing subcategories suggest that this result for total manufactures was determined by the export patterns of textiles and garments. Since the mid-1970s, export growth of manufac-

tures has primarily reflected growth in this category (Rajapatirana 1988). Its share in total manufactured exports increased from 30 percent in 1970–72 to 75 percent in 1983–85. While factors exogenous to the domestic exchange rate and trade policy scene were very important, the trade liberalization in 1977 and the receptive approach of the government toward foreign investors undoubtedly provided the groundwork for exploiting those opportunities. This is borne out by the highly significant coefficient for LBD in the equation for textiles and garments. The coefficient of REER for other manufactures is highly significant and suggests a 1.5 percent response to a given percentage point change in lagged relative prices. The interpretation is that even when allowance is made for the special factors affecting exports of garments, exchange rate and incentive policies were important influences on the promotion of manufactured exports.

In sum, our estimates generally support the view that Sri Lankan exports in the aggregate are price inelastic in the short run. The weighted-average elasticity coefficient obtained from the desegregated regressions (treating all insignificant coefficients as zero) is 0.42. At the same time, the results suggest that even in the short run an active exchange rate and export incentive policy could have played an important role in promoting new export lines.

Appendix II

Notes on the Statistics

Sri Lankan statistics on the economy suffer from a number of serious limitations, even though Snodgrass has argued that “the body of statistics available for Ceylon (Sri Lanka) must certainly rank as one of the most complete and accurate in the world for a country of such low per capita income” (Snodgrass 1966:300; see also Pyatt and Roe 1977:35, for a similar observation). In this section we point out some of the major limitations.¹

Sources

A large number of Sri Lankan agencies are engaged in data collection, and their published figures often show discrepancies. For example, the Central Bank and the Department of Census and Statistics (DCS) compile data on many aggregate economic variables. They produce independent sets of national income accounts that are often at variance with each other. Hence, different sets of global estimates of gross domestic product, gross national product, and their components are available, both at current and constant prices. Such discrepancies between sources are found in many other statistics, including those relating to the domestic price level, foreign trade, and employment.

In this study we generally rely on published Central Bank statistics and supplement them from other sources where it is felt to be desirable. One important reason for our choice is that more recent data are published by the Central Bank, whereas the DCS data are normally available only after a considerable delay. However, there are problems of consistency in the Central Bank data. Data series found in the documents of international financial institutions that give the Central Bank as their primary source are often at variance with data given in Central Bank publications. The conflicts in the mid-1980s then raised problems in the collection of certain data series, and even certain key statistics (such as GDP) need to be treated with caution.

National Accounts

The Central Bank started compiling its national accounts in 1959 and has revised the method of compilation a number of times, the latest significant revisions being in 1978 and in 1983.²

The new series is available from 1982 in the Central Bank's annual report, and Savundranayagam (1983) has unified and revised the figures for the previous years back to 1950 in line with 1978 revisions. The Central Bank series (defined to include both the "Savundranayagam" data and "official" Central Bank data) conforms more closely with the UN system of National Accounts. However, problems remain:

A substantial proportion of the variables (comprising one third of GDP in 1970) are estimated indirectly, and some variables (about 15 percent) are assumed to grow at a steady trend rate of growth.

The operation of a dual exchange rate system in 1968–77 created problems in imputing correct prices to tradable goods. In the latest revisions to Central Bank series for this period, all external transactions have been valued at the higher FEEC-inclusive rate on the assumption that it would be a reasonable proxy for the rate that would have prevailed in the absence of controls. However, the considerable differences observable between the FEEC-inclusive rate and the curb market rate, and year-to-year changes in these differences (table SA-15), suggest that this may not be entirely appropriate.

There are some differences between estimates arrived at by the "product method" and those arrived at by the "expenditure" method, and since about 1982 there has been a considerable enlarging of these differences. There are reasons to suspect that the former may have overstated the level of economic activity (Jayawardena, Maasland, and Radhakrishnan). For this reason we used expenditure account data in constructing the activity variable to be used in our regression analysis of savings and investment. However, in analyzing growth performance on a sectoral basis, there is no alternative to product-account data.

In constructing constant price series, the current figures for the services sector are usually deflated by the Colombo Consumer Price Index (CCPI) and the wage rate indices for workers.³

The CCPI, as discussed below, is a very poor index for such use. Likewise, since the Wages Boards report wage rates only in the organized sector, the wage rate index does not properly reflect wage changes in the large unorganized sector. These facts should be borne in mind when using the implicit GDP deflator rather than the CCPI for inflation adjustments; the two series are not entirely independent.

Employment Data

Employment data are perhaps the weakest link in the Sri Lankan national data system. There are no data on overall employment which are directly compiled and

published on an annual basis. Snodgrass (1966) and Hallett (1981) provide total employment series constructed using data from periodic surveys, supplemented with International Labor Organization (ILO) population projections for the periods 1950-59 and 1960-79, respectively.

The various surveys of employment available to analyze changes in employment and unemployment over time (as listed in table 3.7) have often used different definitions, making strict comparisons impossible. Annual figures on employment are available only for the "organized" sector, which accounts for only 10 to 15 percent of total employment. In general, unemployment figures should be treated with great caution.

Trade Data

Trade data are produced by the Central Bank as well as the DCS. Further, trade data for particular commodities are also available from other sources, such as the Food Commissioner's Department, the Petroleum Corporation, and the Gem Corporation. The Central Bank adjusts the figures obtained from customs records, using data obtained from these various sources. Substantial discrepancies are present between the trade data from different sources. Sri Lanka's import data are presented only on a CIF basis. Naturally, these trade figures do not capture the effects of extensive underinvoicing of imports and overinvoicing of exports. Note also that the import and export price indices published by the Central Bank are really unit value indices rather than true price indices. Aggregate export unit value indices become quite misleading indicators of the underlying price movements when the composition of the product categories changes substantially. This has certainly occurred in Sri Lanka since the late 1970s, with the notable shift in the export structure from primary commodities to manufactured exports. Thus, the terms of trade movements indicated by the available series should be used with caution.

Fiscal and Monetary Data

These are probably the best data available at a disaggregated level.

Wages

Available data going back to 1950 refer only to the minimum wages in the organized sector that, in many cases, represents only a minority of wage earners. Further, the ratios between minimum wage and total wage earnings vary between

years and sectors. Informal sector wage data are available (from Central Bank sources), in most cases, from the mid- or late-1970s only.

Price Data

The two longest time series available are the CCPI and the implicit GDP deflator.⁴

Bhalla (1987) has presented a revised version of the CCPI for the period 1952–86). A WPI and an (unpublished) Central Bank Consumer Price Index (CBCPI) have been in existence since 1974. A Construction Cost Price Index (CCI) has been available since 1977.

The CCPI, though the most widely used price index, suffers from major problems. It is based on a set of weights based on a 1949–50 family budget survey covering 455 working-class households in Colombo. The small sample was unrepresentative of the wider community even at that time. Colombo workers' families constituted only three to five percent of the total population, and there were major differences in the expenditure patterns between different groups. The set of weights and the basket of goods used in 1952 have continued in use despite large changes in expenditure patterns. Furthermore, weighted average prices of controlled goods have been calculated on the basis of a constant set of weights between open and controlled market prices. These weights have little correspondence to the relative household expenditures on the two categories. Typically, black market prices are not captured, which makes the index a particularly poor guide to price movements during the early 1970s, when rationing and widespread scarcities resulted in thriving black markets for many consumer goods. Generally, the CCPI underestimates actual price changes. For instance, using survey data provided by the DCS, Bhalla (1987) found that food grain prices rose by over 380 percent during the 1970s, as against 166 percent indicated by the CCPI. Furthermore, the subindex for expenditure on house rent shows practically no increase over 30 years.

The adjustment of the CCPI by Bhalla (1987) involved the replacement of controlled prices for the food and rent components of the index with open market prices. In this study we generally use the Bhalla-adjusted CCPI (BACCPPI) rather than the original CCPI as the measure of consumer price movements.

As noted above, in national accounts the constant price estimates of value added in services sectors are derived using the CCPI and wage rate indexes. Therefore, the overall GDP deflator suffers from the above-mentioned limitations of these base indices. But the implicit deflator estimated separately for the tradable sectors can be considered a more reliable indicator of price changes at the producer level than the overall GDP deflator. This is because constant price estimates for these sectors are directly obtained using volume indices, which are considered to be fairly reliable (Ranaweera 1978).

The CBCPI has been developed to overcome some of the major weaknesses of the CCPI and is considered to give a much higher weight to tradable goods and open-market prices. For reasons that have not been made public, this index is not publicly available.

Table SA-1 Gross Domestic Product (GDP), Mid-year Population (POP), Per Capita GDP (PGDP), and their Growth Rates, 1950–89
(1970 prices)

Year	GDP ^a (millions of rupees)	POP (thousands)	PGDP ^a (rupees)	Growth rates (percent)		
				GDP	POP	PGDP
1950	6,669	7,678	868	—	—	—
1951	7,084	7,876	899	6.2	2.6	3.6
1952	7,409	8,074	917	4.5	2.5	2.1
1953	7,553	8,290	911	1.9	2.6	-0.7
1954	7,758	8,520	910	2.7	2.8	-0.1
1955	8,212	8,723	941	5.8	2.4	3.4
1956	8,266	8,929	925	0.7	2.4	-1.7
1957	8,387	9,165	915	1.5	2.6	-1.2
1958	8,631	9,388	919	2.9	2.4	0.5
1959	8,752	9,620	910	1.4	2.5	-1.1
1960	9,074	9,900	917	3.7	2.9	0.8
1961	9,260	10,140	913	2.0	2.4	-0.4
1962	9,593	10,380	924	3.6	2.4	1.2
1963	9,791	10,650	919	2.1	2.6	-0.5
1964	10,257	10,900	941	4.8	2.3	2.4
1965	10,579	11,160	948	3.1	2.4	0.8
1966	10,961	11,440	958	3.6	2.5	1.1
1967	11,417	11,700	975	4.2	2.3	1.9
1968	12,269	11,990	1,023	7.5	2.5	5.0
1969	12,857	12,250	1,049	4.8	2.2	2.6
1970	13,364	12,520	1,067	3.9	2.2	1.7
1971	13,251	12,690	1,050	-0.8	1.4	-2.2
1972	13,530	12,860	1,052	2.1	1.3	0.8
1973	14,078	13,091	1,075	4.1	1.8	2.2
1974	14,536	13,284	1,094	3.3	1.5	1.8
1975	14,873	13,496	1,101	2.3	1.6	0.7
1976	15,312	13,720	1,116	2.9	1.7	1.3
1977	16,021	13,942	1,149	4.6	1.6	3.0
1978	17,329	14,190	1,221	8.2	1.8	6.4
1979	18,461	14,470	1,275	6.5	2.0	4.6
1980	19,468	14,740	1,320	5.5	1.8	3.6
1981	20,651	14,897	1,377	6.1	1.1	5.0
1982	22,482	15,189	1,550	4.8 ^b	2.0	2.8 ^b
1983	23,604	15,420	1,574	4.9	1.5	3.5
1984	24,796	15,599	1,574	5.1	1.2	3.9
1985	26,026	15,840	1,627	4.9	1.5	3.4
1986	27,140	16,117	1,668	4.3	1.7	2.5
1987	27,534	16,361	1,667	1.5	1.5	-0.1
1988	28,277	16,586	1,689	2.7	1.4	1.3
1989	28,914	16,808	1,704	2.3	1.3	0.9

a. The new (1982–89) GDP series has been linked to the old (1950–81) series by deflating the joined current price series by the GDP deflator (1970 = 100). Figures for the two subperiods are not strictly comparable because of differences in the method of compilation.

b. Growth rates based on the old series.

Source: Savundranayagam (1983), for the 1950–81 period; Central Bank of Ceylon, *Annual Report* (annual).

Table SA-2 Gross Domestic Fixed Capital Formation, 1966–88

Year	As a percentage of GDP ^a				At constant (1970) prices ^b			
	Government	Public corporations	Private	Total	Government	Public corporations	Private	Total
1966	4.6	2.7	6.9	14.2	486	275	772	1,483
1967	4.9	2.1	8.1	15.1	559	237	993	1,729
1968	4.3	2.6	7.7	14.6	513	307	905	1,725
1969	4.8	2.9	11.8	19.5	841	344	1,420	2,605
1970	4.1	3.3	9.8	17.2	570	451	1,338	2,359
1971	3.5	2.6	8.9	15.2	465	346	1,208	2,019
1972	3.3	2.0	9.2	14.5	462	285	1,223	1,970
1973	3.3	1.6	8.6	13.5	433	224	1,175	1,832
1974	3.4	1.4	7.7	12.5	412	174	923	1,509
1975	4.1	1.6	8.2	13.9	491	191	975	1,657
1976	5.4	1.9	7.9	15.2	706	255	1,029	1,990
1977	4.2	2.3	7.3	13.8	468	261	798	1,527
1978	7.3	4.8	7.9	19.9	943	663	1,093	2,749
1979	7.2	5.0	13.0	25.2	1,095	753	1,959	3,807
1980	7.0	11.3	12.9	31.2	1,171	1,879	2,135	5,185
1981	4.8	9.8	12.7	13.2	923	1,870	2,415	5,208
1982	5.1	11.6	15.2	31.9	1,040	2,339	3,091	6,470
1983	5.2	25.8		31.0	1,096	5,400		6,496
1984	5.1	25.2		28.3	1,116	5,123		6,239
1985	5.2	20.7		25.9	1,231	4,863		6,095
1986	5.8	20.0		25.8	1,449	4,916		6,365
1987	5.7	17.6		23.3				
1988	5.8	16.7		22.5				

a. From 1983 onwards, public corporations and private sector investment figures are not available in disaggregated form.

b. Estimated using GDP (nontradable) deflator.

Source: Compiled from data series obtained from Central Bank of Ceylon, *Review of the Economy* (annual) and Savundranayagam (1983).

Table SA-3 Gross Domestic Saving, 1959–87
(percentage of GDP)

<i>Year</i>	<i>Total saving</i>	<i>Private saving</i>
1959	11.2	10.3
1960	10.6	12.2
1961	12.1	12.6
1962	12.2	11.9
1963	13.2	11.8
1964	11.5	12.2
1965	12.3	11.8
1966	10.3	10.7
1967	11.8	11.6
1968	11.6	11.6
1969	9.5	9.0
1970	15.6	16.5
1971	15.1	17.0
1972	15.7	17.0
1973	12.5	11.9
1974	8.2	7.2
1975	8.1	8.6
1976	13.9	14.3
1977	18.1	17.8
1978	15.3	16.6
1979	13.8	13.4
1980	11.2	14.8
1981	11.7	13.5
1982	11.9	13.3
1983	13.8	13.7
1984	19.9	16.1
1985	11.9	8.9
1986	12.0	8.1
1987	12.8	8.7

Note: Ratios have been estimated using current price data.

Source: Central Bank of Ceylon, *Annual Report* (annual) and *Review of the Economy* (annual).

Table SA-4 Sectoral Distribution of Investment, 1966-88

(percentage of gross domestic capital formation)

Sector	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
Gross domestic fixed capital formation	99	99	94	101	91	89	84	99	80	89	94	96	100	98	93	99	99	101	100	99	100	100	99
Private sector and public corporations	67	68	66	76	69	69	64	75	58	63	61	66	64	70	72	81	83	84	82	73	77	75	73
Planting, replanting and land development	6	6	5	4	4	5	4	4	3	3	2	2	2	1	1	1	1	1	1	2	3	2	2
Building and other construction	33	38	41	36	38	41	35	41	36	31	32	28	26	28	33	29	29	34	35	35	41	41	41
Plant and machinery	14	11	10	17	12	12	9	15	5	13	14	17	18	17	17	18	21	24	22	19	20	21	20
Transport equipment	9	6	4	14	9	7	11	10	7	9	6	10	11	15	20	21	23	15	11	9	5	4	4
Other capital goods	5	7	5	4	5	4	5	5	7	8	7	9	7	8	5	8	9	9	13	9	9	7	6
Government and public enterprises	33	32	28	25	22	21	20	23	22	26	33	29	36	28	21	17	16	17	18	27	23	24	25
Changes in stocks:	1	1	6	-1	9	11	16	1	20	11	6	4	1	2	7	1	1	-1	1	1	0	0	1
Private sector and public corporations	4	-2	2	7	1	5	-1	3	1	-1	-2	5	3	3	2	1	0	1	0	0	0	1	—
Government and public enterprises	-3	-4	-3	1	10	12	3	18	10	7	6	-4	0	4	-1	0	0	0	0	0	0	0	—
Gross domestic capital formation	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
Private sector	48	54	48	61	57	33	55	55	50	52	50	50	45	51	40	47	48	83	82	73	77	76	74
Public corporations	22	14	16	15	20	36	14	19	10	11	10	15	23	21	34	36	36	0	0	0	0	0	0
Government and public enterprises	30	32	27	25	23	31	31	26	39	36	40	35	32	28	25	17	16	17	18	27	23	24	26

Note: Figures may not add up to 100 due to rounding; zero means less than 0.5 percent.

Source: Central Bank of Ceylon, *Annual Report* (annual).

Table SA-5 Index of Industrial Production, 1970–89
(1977=100)

<i>Year</i>	<i>Public sector^a</i>	<i>Total^b</i>
1970	81	67
1971	82	68
1972	101	71
1973	100	71
1974	101	60
1975	102	73
1976	103	101
1977	100	100
1978	125	100
1979	111	113
1980	120	117
1981	118	120
1982	125	125
1983	115	126
1984	107	142
1985	118	149
1986	116	165
1987	116	176
1988	114	188
1989	90	198

a. Central Bank's Public Sector Major Industry Output Index.

b. Compiled using data relating to real manufacturing value added (excluding processing of plantation products) obtained from national income accounts.

Source: Based on Central Bank of Ceylon, *Review of the Economy* (annual).

Table SA-6 Production of Major Agricultural Crops, 1960-89

<i>Year</i>	<i>Tea (millions of kilograms)</i>	<i>Rubber (millions of kilograms)</i>	<i>Coconut (millions of nuts)</i>	<i>Paddy (thousands of metric tons)</i>
1960	197	99	2,183	901
1961	207	98	2,601	903
1962	212	104	2,811	1,005
1963	220	105	2,549	1,028
1964	219	117	2,991	1,055
1965	228	118	2,676	759
1966	222	131	2,461	955
1967	221	143	2,416	1,152
1968	225	149	2,601	1,350
1969	220	151	2,440	1,377
1970	212	159	2,510	1,616
1971	218	142	2,610	1,396
1972	214	140	2,963	1,312
1973	211	155	1,935	1,312
1974	204	132	2,031	1,602
1975	214	149	2,398	1,154
1976	196	152	2,330	1,253
1977	209	146	1,821	1,677
1978	199	156	2,207	1,891
1979	206	153	2,393	1,917
1980	191	133	2,026	2,133
1981	210	124	2,258	2,230
1982	188	125	2,521	2,156
1983	179	140	2,398	2,479
1984	208	142	1,983	2,420
1985	214	138	2,958	2,661
1986	211	138	3,059	2,588
1987	213	122	2,487	2,128
1988	227	122	1,996	2,477
1989	207	111	2,517	2,063

Source: Central Bank of Ceylon, *Annual Report* (annual).

Table SA-7 Basic Indicators of the General Price Level, 1950-89

<i>Year</i>	<i>CCPI</i>	<i>GDPD</i>	<i>WPI</i>	<i>CBCPI</i>	<i>BACCPi</i>
1950	—	60.47	—	—	—
1951	62.12	—	—	—	—
1952	100.00	58.48	—	—	98.3
1953	100.30	61.32	—	—	99.9
1954	101.40	63.86	—	—	96.3
1955	102.00	63.13	—	—	98.0
1956	102.60	64.17	—	—	100.0
1957	102.80	67.29	—	—	102.0
1958	105.00	69.93	—	—	106.3
1959	105.20	71.49	—	—	107.1
1960	103.20	76.69	—	—	107.0
1961	104.80	75.53	—	—	108.8
1962	106.30	75.24	—	—	110.4
1963	108.80	76.20	—	—	112.9
1964	112.20	77.04	—	—	117.4
1965	112.50	75.32	—	—	117.5
1966	112.30	77.94	—	—	116.1
1967	114.80	80.19	—	—	120.7
1968	121.50	91.96	—	—	126.0
1969	130.50	100.21	—	—	138.2
1970	138.20	100.00	—	—	142.9
1971	141.90	103.45	—	—	148.9
1972	150.80	110.85	—	—	171.0
1973	165.80	128.20	—	—	216.4
1974	185.80	15.00	10.00	100.00	289.5
1975	198.30	17.00	10.00	103.00	300.5
1976	200.70	18.00	11.00	107.00	316.2
1977	203.20	21.00	13.00	123.00	348.4
1978	227.30	23.00	15.00	134.00	385.7
1979	252.20	25.00	17.00	159.00	462.3
1980	318.20	30.00	22.00	218.00	603.4
1981	375.40	35.00	26.00	270.00	749.2
1982	416.10	42.00	28.00	300.00	815.6
1983	474.20	48.00	35.00	334.00	932.2
1984	553.10	56.00	444.70	1,086.00	—
1985	561.20	56.00	377.10	1,106.70	—
1986	606.00	60.00	366.00	1,201.90	—
1987	652.80	64.00	414.90	—	—
1988	744.10	71.00	488.70	—	—
1989	830.20	78.00	532.90	—	—

Note: CCPI = Colombo Consumer Price Index (1952 = 100). GDPD = Gross Domestic Product Deflator (1970 = 100). WPI = Wholesale Price Index (1974 = 100). CBCPI = Central Bank Consumer Price Index (1974 = 100) (unpublished). BACCPi = Bhalla-adjusted CCPI (CCPI as adjusted by Bhalla (1986) by replacing controlled prices of food and rent components by open-market prices.)

Source: CCPI and WPI: Central Bank of Ceylon, *Annual Report* (annual). GDPD: Compiled from sources listed in table SA-1. CBCPI: World Bank data files. BACCPi: Bhalla (1986).

Table SA-8 Wage Rate Indices, 1965–89
(1978 = 100)

Year	<i>Workers in wages board trade^a</i>		<i>Government employees^b</i>	
	<i>Nominal</i>	<i>Real^c</i>	<i>Nominal</i>	<i>Real^c</i>
1965	26.5	86.9	45.2	148.2
1966	26.7	88.7	46.0	152.8
1967	27.8	89.4	47.7	153.3
1968	31.9	97.6	55.5	169.7
1969	31.9	89.1	57.1	159.5
1970	32.3	87.2	62.1	167.8
1971	32.8	85.0	62.1	160.8
1972	35.5	80.1	62.3	140.6
1973	38.4	68.4	65.5	116.8
1974	48.1	64.1	73.7	98.3
1975	55.3	71.0	81.5	104.6
1976	56.7	69.1	86.1	105.0
1977	69.8	77.2	87.2	96.6
1978	100.0	100.0	100.0	100.0
1979	119.6	99.8	117.2	97.8
1980	147.3	94.2	129.1	82.5
1981	152.2	98.4	146.1	75.3
1982	175.8	83.2	187.8	88.4
1983	188.8	78.1	215.7	89.3
1984	228.8	81.3	246.4	87.7
1985	247.9	86.5	297.3	99.1
1986	261.3	83.6	297.4	95.2
1987	277.7	82.7	297.4	88.5
1988	335.8	87.6	390.0	101.5
1989	388.1	90.8	421.8	99.1

a. Refers to minimum wages of tea growing and manufacturing, rubber growing and manufacturing, coconut growing and manufactures, engineering, printing, transport, match manufacturing, building, dock, tea, rubber and cinnamon trade.

b. Refers to wages of all central government employees.

c. Nominal wage rate index deflated by the Bhalla-adjusted Consumer Price Index up to 1986, and by the Colombo Consumer Price Index.

Source: Nominal wage rate indices: Central Bank of Ceylon, *Annual Report* (annual)—the old series (base 1952) has been spliced to the base of the new series (1978). Consumer Price Indexes: as in table SA-6.

Table SA-9 Terms of Trade Between Agriculture and Industry, 1960–85
(1970 = 100)

Year	Implicit deflator for agriculture			Implicit deflator for terms of trade			
	Plantations ^a	Domestic	Total	Manufacturing ^b (agriculture/manufacturing)			
1960	87.4	76.2	83.0	79.8	109.5	95.5	104.0
1961	81.5	73.0	78.2	81.5	100.0	93.4	96.0
1962	80.9	70.6	76.7	82.7	97.8	85.4	92.7
1963	73.1	71.2	72.3	82.4	88.7	86.4	87.7
1964	80.4	72.2	77.0	84.7	94.9	85.2	90.9
1965	85.7	69.7	80.1	91.8	93.4	75.9	87.3
1966	84.7	71.6	79.5	85.3	99.3	83.9	93.2
1967	75.8	86.1	80.3	89.2	85.0	96.5	90.0
1968	94.6	101.9	98.0	94.7	99.9	107.6	103.5
1969	104.6	100.0	102.3	97.8	107.0	102.2	104.6
1970	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1971	101.8	100.0	108.2	90.9	94.1	98.4	90.9
1971	98.4	101.8	100.0	108.2	90.9	94.1	92.5
1973	125.8	155.9	142.7	138.2	91.0	112.8	103.3
1974	189.0	247.3	224.3	174.8	108.1	141.5	128.3
1975	169.6	275.2	227.7	231.5	73.3	118.9	98.4
1976	204.7	248.9	231.0	205.8	99.5	120.9	112.2
1977	315.3	237.8	265.0	248.0	127.1	95.9	106.9
1978	353.6	280.4	306.0	259.8	136.1	107.9	117.8
1979	412.3	248.4	308.3	325.0	126.9	76.4	94.9
1980	501.8	343.8	394.5	382.6	131.2	90.0	103.1
1981	569.7	383.2	443.1	452.3	126.0	84.7	98.0
1982	585.4	384.3	423.1	500.5	117.0	76.8	86.3
1983	807.9	455.4	535.8	548.0	147.4	83.1	97.7
1984	1,107.0	558.0	678.8	596.6	185.6	93.5	113.7
1985	769.2	581.4	627.8	625.1	123.1	93.0	100.4

a. Tea, rubber and coconut production and processing for exports.

b. Manufacturing excluding processing of tea, rubber, and coconuts.

Source: Estimated using data from Savundranayagam (1983) (for the period 1960–81) and Central Bank of Ceylon, *Review of the Economy* (1983), and *Annual Report* (1985).

Table SA-10 Summary of Government Fiscal Operations, 1966–88 (millions of rupees)

Items	1966	1968	1970	1972	1974	1976	1978	1980	1982	1984	1986	1988 ^a
Current revenue	1,233	2,156	2,815	4,034	5,084	5,739	11,688	14,068	17,809	37,731	41,644	45,675
Expenditure	2,515	3,006	3,886	4,647	6,386	9,314	18,853	30,343	37,900	53,592	69,715	88,916
Recurrent expenditure	1,860	2,186	2,659	3,386	4,506	5,534	10,408	13,249	20,110	28,926	34,722	46,613
Capital expenditure	644	849	1,026	1,207	1,841	3,448	6,614	13,845	18,669	21,750	35,112	44,620
Recurrent expenditure	1,860	-29	201	54	39	312	1,831	3,240	-879	2,916	-170	2,732
Budget deficit	682	850	1,150	1,366	1,599	3,576	7,165	16,274	20,091	15,861	28,071	36,176
Debt repayment	116	135	214	330	564	662	1,165	1,810	2,612	2,229	7,525	8,441
Net cash deficit	566	716	936	1,306	1,035	2,914	6,000	14,772	17,479	13,632	20,546	34,800
<i>Financing of budget deficit</i>												
Domestic non-market borrowing	112	10	16	199	-54	485	453	-216	1,713	904	-660	1,685
Domestic market borrowing	498	630	815	803	964	1,799	2,200	9,826	9,899	3,041	12,137	16,451
Foreign finance	154	247	345	478	650	1,326	4,454	6,735	8,794	11,251	15,834	18,925
Decline in cash balance	-82	-36	-26	-115	39	33	58	-72	-315	666	760	-885
<i>Financing of net cash deficit</i>												
Domestic non-market borrowing	112	10	16	199	-54	485	280	-487	1,664	807	-667	1,673
Domestic market borrowing	418	552	720	668	671	1,505	1,710	9,195	8,010	2,374	7,639	20,296
Foreign finance	188	190	226	284	378	957	3,953	6,136	8,112	9,785	12,814	13,716
Decline in cash balance	-82	-36	-26	115	39	-33	58	-72	-315	666	760	-885
Expansionary impact of fiscal operations	122	267	425	112	24	605	173	7,029	3,765	-2,095	3,047	10,153
Public debt outstanding	4,268	5,689	7,237	7,558	11,027	15,621	27,746	46,779	71,250	95,741	149,690	220,003
<i>As percentage of GDP</i>												
Revenue	23.6	21.7	20.7	22.2	20.5	20.4	28.8	22.6	19.4	26.9	23.1	20.6
Aggregate expenditure	32.4	30.2	29.4	31.5	27.4	33.2	46.5	48.7	41.3	38.3	38.7	40.0
Recurrent expenditure	24.0	22.0	20.1	23.0	19.3	19.8	25.7	21.2	21.9	20.7	19.3	21.0
Government savings	-0.3	-0.3	0.5	0.7	1.2	0.6	3.1	0.3	-2.5	6.3	3.8	-0.4
Budget deficit	8.8	8.5	8.7	9.2	6.8	12.7	17.7	26.1	21.0	11.3	15.6	15.7
Expansionary impact of fiscal operations	1.5	2.5	3.2	0.8	0.1	2.3	0.4	10.3	5.8	1.5	1.7	4.6

a. Provisional.

Source: Central Bank of Ceylon, *Annual Report* (annual) and *Review of the Economy* (annual).

Table SA-11 Budgetary Transfers to Public Enterprises, 1960–89
(millions of rupees)

Year ^a	Transfers			Current transfers as percent of total	Total transfers	
	Current	Capital	Total		As percent of government expenditure	As percent of budget deficit
1960	—	70	70	—	3.9	12.5
1961	—	73	73	—	3.7	13.5
1962	—	101	101	—	4.9	15.2
1963	—	115	115	—	5.8	14.6
1964	—	87	87	—	3.9	20.1
1965	—	147	147	—	6.0	19.3
1966	3	152	155	1.6	5.9	22.5
1967	1	199	200	0.5	7.1	27.7
1968	7	210	217	3.0	6.9	25.5
1969	12	286	298	4.2	8.3	31.5
1970	12	283	295	4.2	7.5	25.6
1971	24	281	305	7.8	7.7	23.0
1972	28	333	361	7.8	6.7	24.4
1973	166	385	551	30.1	10.9	38.7
1974	164	378	542	30.3	9.3	33.9
1975	134	770	904	14.8	12.6	33.5
1976	129	965	1,094	11.8	12.6	30.5
1977	146	868	1,014	14.4	11.5	33.0
1978	1,081	2,070	3,151	34.3	17.8	44.0
1979	920	3,112	4,032	22.8	19.8	46.0
1980	1,583	6,086	7,669	20.7	26.9	47.1
1981	1,350	7,174	8,524	15.8	28.9	57.1
1982	845	10,591	11,436	8.0	30.2	56.9
1983	1,275	10,123	11,398	11.2	24.3	52.8
1984	1,082	12,192	13,274	8.2	24.8	83.7
1985	751	11,592	12,343	6.1	19.1	48.1
1986	1,936	14,174	16,110	12.0	23.1	57.4
1987	1,264	10,721	11,985	10.5	16.6	43.8
1988 ^b	1,725	9,683	11,408	15.1	12.8	31.5
1960–69 ^c	—	—	2.3	5.6	17.1	—
1970–75 ^c	—	—	15.3	9.6	29.9	—
1977–89 ^c	—	—	14.9	21.3	39.1	—

a. Data for the period 1960–71 are for the fiscal year, for other years on a calendar-year basis.

b. Provisional.

c. Annual averages; figures for 1960–69 are for 1966–69 period only.

Source: Compiled from data from Central Bank of Ceylon, *Review of the Economy* (annual).

Table SA-12 End-of-year Foreign Reserves, 1950–89

<i>Year</i>	<i>Import-month</i>	<i>SDR millions equivalent^a</i>
1950	227.5	11.1
1951	244.3	9.0
1952	171.2	5.7
1953	121.0	4.2
1954	188.4	7.9
1955	242.4	9.4
1956	230.8	9.1
1957	204.4	6.6
1958	176.1	5.9
1959	137.6	4.0
1960	96.2	2.7
1961	92.7	3.0
1962	85.5	2.5
1963	75.4	2.3
1964	64.1	1.9
1965	85.7	2.6
1966	59.2	1.7
1967	85.5	2.5
1968	70.1	2.1
1969	55.1	1.5
1970	61.7	1.9
1971	74.2	2.5
1972	100.3	3.7
1973	119.0	3.6
1974	92.6	2.2
1975	92.4	1.9
1976	136.9	3.1
1977	294.8	10.6
1978	370.1	5.9
1979	475.5	5.1
1980	295.5	2.4
1981	387.2	3.1
1982	477.7	3.3
1983	498.5	3.5
1984	735.1	4.0
1985	610.9	3.5
1986	491.7	3.5
1987	423.3	3.2
1988	428.1	3.1
1989	446.8	3.1

a. Estimated by dividing end-of-year reserves by the average monthly import requirement during the year.

Source: Central Bank of Ceylon, *Review of the Economy* (annual) and *Annual Report* (annual).

Table SA-13 Import Structure, 1950–89*(percentage shares)*

Year	Consumer goods			Intermediate goods		Investment goods	Investment goods
	Total	Food	Other	Total	Oil		
1950	72.2	45.0	23.2	15.2	5.2	12.6	27.8
1955	66.6	45.7	20.5	18.4	8.7	15.0	33.4
1959	60.0	39.9	20.1	19.8	6.7	19.4	40.0
1960	61.0	38.3	22.6	20.1	6.3	18.1	39.0
1961	57.1	39.5	17.6	22.5	7.5	20.0	42.9
1962	54.6	38.0	16.6	24.6	7.6	20.3	45.4
1963	52.4	42.2	10.2	25.0	8.0	21.7	47.6
1964	64.0	51.4	12.6	20.0	4.7	15.4	36.0
1965	52.9	41.0	11.9	28.1	7.4	17.7	47.1
1966	57.3	47.1	10.1	23.2	6.4	17.8	42.7
1967	53.6	45.1	8.5	25.4	6.4	19.0	46.4
1968	52.8	45.5	7.2	29.0	9.0	17.6	47.2
1969	48.0	38.4	9.5	23.3	6.1	27.5	52.0
1970	56.0	46.3	9.7	20.0	2.5	23.6	44.0
1971	57.2	46.3	10.9	20.7	1.3	21.1	42.8
1972	51.8	44.4	7.4	24.3	1.8	21.2	48.2
1973	52.5	46.0	6.5	30.0	10.9	16.7	47.5
1974	47.0	42.9	4.1	42.2	19.9	10.4	53.0
1975	50.5	48.0	2.5	36.0	16.6	12.4	49.5
1976	36.4	32.2	4.2	48.6	25.1	13.8	63.6
1977	42.2	36.3	5.9	44.1	24.0	12.4	57.8
1978	38.3	28.1	10.1	38.1	16.4	22.9	61.7
1979	34.7	21.3	13.4	40.5	17.4	24.2	65.3
1980	29.9	18.9	11.0	47.7	23.8	24.0	70.1
1981	25.2	13.4	11.8	52.7	27.2	21.7	74.8
1982	20.5	8.5	12.1	51.6	29.3	27.6	79.5
1983	25.6	11.8	13.8	47.7	24.2	26.5	74.4
1984	17.0	10.5	6.5	56.2	22.5	25.6	81.8
1985	19.4	10.9	8.4	54.2	20.3	19.2	73.4
1986	22.5	12.4	110.1	52.4	11.5	19.4	71.8
1987	22.8	12.3	10.5	57.2	14.4	18.7	75.9
1988	24.5	14.4	10.2	56.8	11.0	17.0	73.8
1989	26.1	16.4	9.7	56.4	10.4	15.0	71.4

Note: Textile and clothing imports previously classified as consumer goods are classified as intermediate goods from 1984 onwards.

Source: Central Bank of Ceylon, *Annual Report* (1950–85), and *Review of the Economy* (1974–88).

Table SA-14 Commodity Exports, 1966-86

Commodity	Note	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Major agricultural products	(a)	328.0	317.6	306.6	288.6	302.6	271.1	250.0	261.8	310.4	352.3	345.8	457.5	489.6	472.3	441.9	456.4	420.5	499.4	790.4	613.7	409.8
	(b)	-82.7	-3.2	-3.4	-6.0	4.9	-10.5	-7.7	4.3	18.5	—	—	32.3	7.1	-3.5	-6.4	-3.3	-17.8	18.7	58.2	-32.4	-33.3
	(c)	—	—	—	—	90.3	—	—	—	—	83.0	—	—	—	—	65.7	—	—	—	—	—	—
Tea	(a)	215.6	222.7	195.1	178.3	188.4	195.5	171.4	165.2	169.3	228.9	215.8	336.1	336.9	284.3	286.7	284.3	275.9	329.8	604.5	434.5	381.2
	(b)	-15.2	3.2	-12.4	-7.7	5.7	2.2	-11.0	-3.5	2.6	35.2	-5.7	55.1	-2.8	-13.5	0.9	0.9	-2.9	19.5	83.3	-28.1	-35.3
	(c)	—	—	—	—	56.2	—	—	—	—	54.0	—	—	—	—	—	—	—	—	—	—	29.1
Rubber	(a)	70.9	59.3	55.5	72.4	73.9	31.6	39.1	77.6	92.0	77.5	91.5	89.3	103.1	123.6	120.2	127.5	101.0	114.5	126.4	92.9	79.7
	(b)	11.1	-16.4	-6.5	30.4	2.1	-51.3	23.7	98.9	18.5	15.7	18.1	2.3	15.3	19.9	2.7	5.8	-20.5	12.3	11.4	-26.7	-14.2
	(c)	—	—	—	—	22.0	—	—	—	—	18.2	—	—	—	—	17.8	—	—	—	—	—	8.3
Coconut kernel products	(a)	41.5	35.6	56.0	37.9	40.3	47.0	39.5	19.0	49.1	45.9	38.5	32.1	49.6	64.4	35.0	44.6	43.6	56.1	59.5	86.3	48.9
	(b)	-18.3	-14.3	57.3	-32.3	6.3	16.6	16.0	-51.1	159.4	-6.5	-12.2	-16.6	54.5	29.8	-45.7	27.4	-2.2	28.6	6.0	-45.0	-43.3
	(c)	—	—	—	—	12.1	—	—	—	—	10.8	—	—	—	—	5.2	—	—	—	—	—	5.1
Minor agricultural products	(a)	18.9	18.8	19.2	20.5	21.6	21.5	20.4	26.1	38.6	29.6	36.6	48.0	51.8	63.4	63.1	80.5	86.6	79.4	75.0	75.1	69.3
	(b)	-10.0	-0.5	1.1	0.3	5.3	-0.5	-5.1	27.9	47.8	-23.3	23.6	31.1	7.9	22.4	-0.5	27.6	7.5	8.3	-5.5	0.1	-7.6
	(c)	—	—	—	—	6.4	—	—	—	—	7.0	—	—	—	—	9.4	—	—	—	—	—	7.1
Minerals	(a)	3.0	2.4	2.1	2.2	2.9	2.9	4.2	21.0	16.7	24.4	30.0	31.4	32.1	31.5	37.4	34.9	37.4	45.0	32.0	31.3	35.9
	(b)	—	—	—	—	31.8	—	44.8	400.0	-29.5	46.1	23.0	4.7	2.2	-1.9	18.7	-5.5	7.1	20.3	-28.8	-2.1	14.6
	(c)	—	—	—	—	0.9	—	—	—	—	5.8	—	—	—	—	5.6	—	—	—	—	—	3.7
Gems	(a)	0.8	0.7	0.3	0.1	0.7	0.6	1.8	18.5	16.5	21.3	26.8	28.6	27.1	24.6	30.9	27.9	29.8	37.4	23.6	20.3	23.0
	(b)	—	—	—	—	—	-14.3	2.8	108.1	184.4	2.7	48.0	52.9	12.1	54.3	42.0	38.7	24.7	12.4	51.4	2.0	9.0
	(c)	—	—	—	—	0.2	—	—	—	—	5.0	—	—	—	—	4.6	—	—	—	—	—	2.4
Industrial products	(a)	1.2	1.3	18.0	2.1	4.2	3.6	3.7	7.7	21.9	22.5	33.3	50.9	57.1	88.1	125.1	173.5	217.2	244.0	369.3	377.1	411.0
	(b)	—	—	—	—	—	-14.3	2.8	108.1	184.4	2.7	48.0	52.9	12.1	54.3	42.0	38.7	24.7	12.4	51.4	2.0	9.0
	(c)	—	—	—	—	0.1	—	—	—	—	5.3	—	—	—	—	18.6	—	—	—	—	—	4.3
Textiles and garments	(a)	—	—	0.7	0.6	1.3	1.1	1.0	2.6	4.2	3.8	8.6	15.1	26.5	55.5	84.9	133.3	152.4	183.3	290.1	288.1	292.7
	(b)	—	—	—	—	—	-15.4	-9.0	160.0	61.5	9.6	126.3	75.5	75.5	109.4	53.0	57.0	14.3	23.6	54.1	-0.7	1.5

(Table continues on following page.)

Table SA-14 (continued)

	(c)	—	—	—	—	0.4	—	—	—	—	0.9	—	—	—	—	12.6	—	—	—	—	—	30.0
Petroleum	(a)	—	—	—	—	—	—	2.7	17.5	42.5	41.8	51.3	56.3	48.2	95.8	145.1	148.9	142.8	106.6	126.1	140.3	71.7
	(b)	—	—	—	—	—	—	548.0	142.8	-1.6	22.7	9.7	-14.3	987.7	51.5	2.6	-1.6	-24.4	19.0	11.3	-49.0	
Total commodity																						
exports	(a)	352.1	342.6	332.0	315.2	335.3	324.2	294.0	340.2	429.6	466.2	495.0	658.7	674.2	759.5	817.7	928.3	933.7	997.7	432.1	310.5	035.7
including petroleum	(b)	-12.5	-2.7	3.1	-5.0	6.3	-3.4	-9.4	15.6	26.4	8.6	6.2	33.1	2.4	12.7	7.5	13.5	0.6	6.9	43.5	-8.5	-29.9
Total commodity																						
exports	(a)	352.1	342.7	332.0	315.2	335.3	324.2	291.3	322.7	387.1	424.4	443.7	602.4	626.0	663.7	672.6	779.4	790.9	891.11	3061	170.2	2964
excluding petroleum	(b)	-12.5	-2.7	-3.0	-5.2	6.4	-3.4	-10.1	10.8	20.0	9.5	4.5	35.9	4.0	6.0	1.3	16.0	1.5	12.6	46.5	-10.4	-17.7

a. Value in million SDR (current).

b. Annual percentage growth.

c. Percentage share in total commodity exports (excluding petroleum).

Source: Central Bank of Ceylon, *Review of the Economy* (annual).

Table SA-15 Nominal Exchange Rates of the Sri Lankan Rupee, 1950–89
(rupees per unit of foreign currency, period average)

Year	SDR	Formal official rate		Curb-market rate (US dollars)
		US dollars normal rate	FEECS rate	
1950–66	4.78	4.78	—	13.00 ^f
1967 ^a	4.86	4.86	—	14.15
1968	5.95	5.95	7.26 ^b	11.35
1969	5.95	5.95	8.91 ^c	12.00
1970	5.95	5.95	9.23	15.20
1971	5.95	5.93	9.23	18.50
1972	6.48	5.95	9.96 ^d	14.40
1973	7.63	6.40	10.56	11.25
1974	8.00	6.65	10.97	12.10
1975	8.50	7.00	11.58	14.80
1976	9.71	8.41	14.57	13.80
1977	10.35	8.87	14.81 ^e	17.75
1978	19.54	15.61	—	21.25
1979	20.12	15.57	—	21.75
1980	21.52	16.53	—	19.60
1981	22.69	19.24	—	21.75
1982	22.97	20.81	—	23.55
1983	25.15	23.52	—	34.60
1984	26.07	25.43	—	34.75
1985	27.58	27.16	—	33.00
1986	32.87	28.02	—	29.25
1987	43.64	29.44	—	—
1988	44.45	31.81	—	—
1989	52.57	36.05	—	—

a. Devaluation of November 1967.

b. Established on May 6 based on a 44 percent rate on normal official exchange rate.

c. Rate raised to 55 percent on June 18.

d. Rate raised to 65 percent on November 11.

e. Abolished on November 15.

f. Figure for 1966. The rate increased from the average level of 6.35 during 1956–59 to 6.8 in 1960 and 11.5 in 1965.

Source: Official exchange rates: IMF, *International Financial Statistics* (annual); Curb-market rate: *World Currency Yearbook*.

Table SA-16 Trade-Weighted Exchange Rate Indexes^a and Related Data, 1970–86*(1980 = 100)*

<i>Year</i>	<i>NERX</i>	<i>WPX</i>	<i>NERM</i>	<i>WPM</i>	<i>MERT</i>	<i>WPT</i>	<i>WPD^b</i>	<i>RERX</i>	<i>RERM</i>	<i>RERT</i>
1970	43.3	37.3	40.6	40.6	41.9	39.1	32.4	49.8	51.0	50.5
1971	47.1	39.0	42.8	44.0	44.0	41.1	33.3	55.1	53.4	54.3
1972	44.4	41.2	44.3	42.9	42.9	42.9	35.4	51.6	52.1	51.9
1973	46.2	48.7	51.6	45.9	45.9	50.2	38.8	58.1	60.6	59.4
1974	47.2	60.1	65.4	46.4	46.4	63.1	43.6	65.1	68.8	67.2
1975	50.3	66.0	69.0	49.5	49.5	67.8	45.0	73.9	75.1	74.7
1976	55.1	70.5	72.0	55.3	55.3	71.2	48.7	79.8	81.9	80.9
1977	58.9	76.9	76.3	59.2	59.2	76.6	59.0	76.8	77.1	76.9
1978	89.8	80.3	79.3	90.3	90.3	79.7	68.3	105.6	105.2	105.3
1979	92.8	88.0	86.1	93.2	93.2	86.8	74.8	109.2	107.5	108.1
1980	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1981	108.5	108.8	107.8	109.2	109.2	108.2	117.0	101.0	101.0	101.0
1982	109.3	108.9	107.5	109.1	109.1	108.0	123.4	96.5	94.9	95.5
1983	121.8	114.8	111.7	121.9	121.9	112.7	154.3	90.6	88.3	89.0
1984	127.5	120.2	116.8	128.1	128.1	118.1	193.9	79.1	77.5	78.1
1985	136.6	118.9	118.2	132.7	132.7	118.5	164.3	98.9	93.5	95.7
1986	155.0	117.4	115.3	157.9	157.9	116.2	159.4	114.1	115.7	115.1

Note: NERX = Export-weighted nominal exchange rate. NERM = Import-weighted nominal exchange rate. MERT = Trade-weighted nominal exchange rate. WPX = Trade-weighted wholesale price index. WPM = Import-weighted wholesale price index. WPT = Trade-weighted wholesale price index. WPD = Domestic (Sri Lankan) wholesale price index. RERX = Export-weighted real exchange rate, NERX x (WPX/WPD) x 100. RERM = Import-weighted real exchange rate, NERM x (WPM/WPD) x 100. RERT = Trade-weighted real exchange rate, NERT x (WPT/WPD) x 100.

a. The estimates are based on bilateral exchange rates (expressed in rupees) for Sri Lanka's 10 major trading partners (accounted for 92 percent of Sri Lanka's foreign trade in 1980) and wholesale price indices (foreign currency) used as weights. For the period 1970–77 nominal exchange rates are adjusted for the "effective" FEECs premium (FEEC rate multiplied by the share of trade covered by FEEC scheme). CRA premium is not taken into account.

b. The Sri Lankan wholesale price index dates from 1974. It was extrapolated to 1970 on the basis of annual changes in the implicit GDP deflator for tradable production.

Source: Compiled using data from IMF, *International Financial Statistics* (annual), and *Directions of Trade* (annual).

Table SA-17 Real Effective Exchange Rate (REER) Indices for Exports, 1965–86
(1980=100)

	1965	1968	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Traditional exports	76	67	64	63	61	58	60	57	68	78	94	91	100	95	86	98	110	94	73
Nontraditional exports	28	30	36	41	47	53	54	59	62	81	80	84	100	101	81	78	80	83	84
minor agricultural																			
products	68	76	74	79	76	72	75	69	05	14	16	13	100	97	90	81	71	69	61
gems	87	30	48	41	85	01	80	74	00	92	28	20	100	100	03	90	91	89	93
manufactures	21	32	31	51	51	56	66	74	84	95	11	89	100	105	04	96	85	93	94
Total exports	50	54	51	52	48	55	57	54	64	76	90	88	100	98	89	70	96	91	80

Note: The REER index shows the change in real return to exporters in local currency from exporting goods worth one unit of foreign currency and is estimated as:

$$REER = [TWER (1 - T_x + SB)] P_x/P_d$$

where $TWER$ = Trade weighted nominal official exchange rate index (1980=100)

T_x = Export tax rate

SB = the rate of total effective subsidies

P_x = Export price index (export unit value index except for gems, for which consumer price index of Japan, the major importing country of Sri Lankan gems, is used).

Source: Cuthbertson and Athukorala (1990) Appendix B, supplemented with IMF, *International Financial Statistics* (for the Japanese CPI).

Table SA-18 Export Indices, Import Indices, and Terms of Trade, 1950-89

(1978 = 100)

Year	Export volume				Export unit value				Import volume				Import unit value				Terms of trade
	Tea	Rubber	Coconut	All exports	Tea	Rubber	Coconut	All exports	Consumer goods	Intermediate goods	Investment goods	All imports	Consumer goods	Intermediate goods	Investment goods	All imports	
1950	71	88	167	79	17	23	15	17	111	81	40	62	11	7	7	8	208
1955	85	74	245	91	22	24	9	19	125	100	60	74	12	8	10	9	201
1960	97	74	164	92	18	25	12	19	174	128	85	101	11	8	12	9	185
1961	101	65	231	95	17	20	9	16	130	124	74	81	11	7	9	9	172
1962	107	74	259	102	17	20	9	16	122	138	84	82	11	7	9	9	178
1963	108	69	205	98	16	18	10	16	101	131	67	70	12	7	10	10	161
1964	107	84	273	107	17	17	11	16	156	130	49	86	14	7	19	12	135
1965	117	88	214	111	16	17	14	16	101	124	42	65	13	7	19	11	142
1966	103	99	169	101	15	17	12	15	157	141	53	89	13	7	19	11	117
1967	112	96	156	105	15	14	11	14	123	135	47	76	13	7	21	11	120
1968	108	109	184	108	17	15	19	17	119	151	46	77	17	8	24	14	117
1969	104	104	152	103	16	20	16	17	115	141	81	82	18	9	26	15	110
1970	108	117	147	107	16	19	17	17	131	116	54	77	18	10	31	16	106
1971	108	94	170	104	17	16	17	17	101	130	50	68	19	11	30	17	99
1972	98	94	211	102	18	14	13	17	135	193	41	67	22	11	25	18	94
1973	107	117	70	103	18	25	17	20	114	64	39	60	28	16	29	24	82
1974	91	93	78	89	23	39	50	31	77	62	23	42	52	27	43	42	72
1975	110	116	141	107	27	28	33	29	83	76	45	52	66	28	43	49	58

1976	103	100	131	102	31	44	34	34	85	92	53	57	48	34	52	44	78
1977	95	98	48	94	57	47	56	55	123	86	62	73	56	48	53	54	102
1978	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
1979	97	93	98	101	92	132	153	109	139	95	144	123	114	196	145	152	72
1980	97	88	44	99	99	143	163	126	116	145	172	140	177	296	160	217	58
1981	97	97	69	102	104	148	149	129	59	143	293	145	255	394	149	282	46
1982	96	95	94	112	103	120	109	119	75	229	251	150	227	448	228	309	38
1983	86	90	93	109	152	146	159	165	116	190	289	180	230	562	298	375	44
1984	109	89	58	127	226	173	289	207	106	218	283	185	239	571	414	415	50
1985	108	88	114	122	174	144	189	183	87	150	264	158	258	504	198	347	53
1986	113	81	118	131	128	160	133	163	92	184	275	180	273	386	258	321	51
1987	110	78	85	133	152	185	173	188	85	194	290	184	321	437	279	364	52
1988	119	73	52	137	161	250	243	214	96	216	231	189	380	496	395	443	48
1989	111	63	107	148	192	243	204	237	90	196	214	250	487	611	431	525	45

Note: Indices from 1978 are based on 1978 weights. The figures prior to 1978 have been spliced to the new index (1978=100). Indices from 1985-89, based on 1981 weights, have been spliced to 1978 = 100. Textile and clothing imports previously classified as consumer goods are classified as intermediate goods in figures from 1985. Export unit value index/import unit value index 100.

Source: Central Bank of Ceylon, *Annual Report* (annual).

Table SA-19 Export Agriculture: Prices, Costs, Export Duties, and Gross Profit Margins, 1950–86

Year	<i>Tea</i>							<i>Rubber</i>						
	<i>BP\$</i>	<i>BP</i>	<i>EDR</i>	<i>NBP^a</i>	<i>PPR^a</i>	<i>COP</i>	<i>GPM^b</i>	<i>BP\$</i>	<i>BP</i>	<i>EDR</i>	<i>NBR^a</i>	<i>PPR^a</i>	<i>COP</i>	<i>GPM^b</i>
1950	1.16	5.56	17.50	4.59	4.65	3.05	52.5	0.70	3.37	4.50	3.21	3.42	—	—
1951	1.20	5.78	20.54	4.59	4.23	3.06	39.8	1.16	5.58	3.10	4.85	4.74	—	—
1952	1.05	5.07	15.84	4.27	3.86	3.07	25.7	0.81	3.88	2.10	3.41	3.94	1.85	112.5
1953	1.13	5.42	16.82	4.51	4.23	2.73	13.4	0.71	3.40	0.00	3.06	2.98	1.88	58.5
1954	1.43	6.86	19.00	5.56	5.76	3.16	82.3	0.63	3.00	11.20	2.66	2.45	1.96	25.0
1955	1.52	7.28	25.10	5.45	4.85	3.25	49.2	0.72	3.44	10.50	3.08	2.82	2.02	39.6
1956	1.37	6.61	21.11	5.24	4.83	3.23	49.5	0.69	3.31	18.00	2.71	3.20	2.01	59.2
1957	1.27	6.13	23.45	4.69	4.10	3.20	28.1	0.66	3.15	20.00	2.52	2.56	1.82	40.1
1958	1.26	6.06	24.85	4.55	3.81	3.15	21.0	0.57	2.73	18.00	2.21	2.05	1.64	25.0
1959	1.25	6.00	18.40	4.90	4.08	3.21	26.4	0.66	3.18	15.20	2.70	2.76	1.65	67.2
1960	1.16	5.88	12.68	5.13	4.14	3.21	28.9	0.74	3.55	13.80	3.06	2.73	1.65	63.4
1961	1.20	5.78	13.21	5.02	4.03	3.10	30.0	0.60	2.88	10.28	2.58	2.22	1.53	45.1
1962	1.17	5.60	14.15	4.81	3.85	2.98	29.1	0.59	2.84	8.92	2.59	2.16	1.47	47.0
1963	1.16	5.57	16.25	4.66	3.70	2.96	25.0	0.56	2.68	6.32	2.51	2.05	1.55	32.2
1964	1.15	5.53	18.32	4.52	3.70	3.04	21.7	0.53	2.53	5.45	2.39	1.98	1.47	34.6
1965	1.13	5.40	17.95	4.43	3.85	3.25	18.5	0.52	2.51	7.24	2.33	2.00	1.61	24.2
1966	1.07	5.14	19.76	4.12	3.45	3.15	9.5	0.52	2.49	4.20	2.39	1.96	1.55	26.5
1967	1.02	4.90	20.79	3.88	3.30	3.26	1.2	0.44	2.13	0.57	2.12	1.74	1.48	17.5
1968	0.94	5.56	19.81	4.46	3.85	3.25	18.5	0.38	2.22	5.44	2.10	1.94	1.64	18.2
1969	0.89	5.27	20.04	4.21	3.37	3.35	0.5	0.51	3.01	15.57	2.54	2.29	1.57	45.8
1970	0.90	5.38	18.99	4.36	3.59	3.35	7.2	0.46	2.73	12.24	2.40	2.00	1.52	31.6
1971	0.93	5.57	17.53	4.59	3.99	3.45	15.7	0.40	2.38	3.20	2.30	1.74	1.68	3.6

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1972	0.98	6.10	17.46	5.03	4.18	3.52	18.8	0.33	2.05	3.77	1.97	1.78	1.65	7.8
1973	0.96	6.12	16.36	5.12	4.23	4.47	-5.3	0.58	3.68	23.91	2.80	2.57	1.87	37.7
1974	1.16	7.76	22.07	6.05	5.88	5.55	5.9	0.86	5.75	38.50	3.54	2.82	2.46	14.6
1975	1.30	9.08	16.90	7.55	6.15	6.70	-8.2	0.58	4.05	21.35	3.19	2.49	2.75	-9.5
1976	1.25	0.49	19.78	8.42	7.80	4.42	2.4	0.77	6.50	22.19	5.06	4.34	3.28	32.3
1977	2.12	8.86	22.39	4.60	3.15	8.19	60.6	0.77	6.85	28.00	4.93	4.51	3.74	20.5
1978	2.13	3.22	49.84	6.66	1.55	1.80	-2.1	0.96	4.90	49.53	7.52	6.92	4.85	42.6
1979	1.96	0.57	47.11	6.17	1.14	3.43	17.1	1.25	9.44	49.69	0.03	9.15	6.80	34.5
1980	2.02	3.41	32.60	2.52	7.73	7.17	3.3	1.30	1.42	53.05	0.06	0.62	8.20	29.5
1981	1.83	5.14	30.35	4.47	7.71	8.73	-5.4	1.14	1.80	48.94	1.13	0.04	8.97	11.9
1982	1.68	5.04	24.89	6.31	2.52	1.97	2.5	0.85	7.68	31.62	2.09	0.18	9.66	5.8
1983	2.23	2.52	25.61	9.06	6.96	6.37	40.1	0.97	2.77	29.72	6.00	3.95	9.90	40.9
1984	3.03	7.20	31.67	2.75	6.45	4.00	36.6	1.03	6.16	30.57	8.17	4.94	2.06	23.8
1985	2.23	0.62	18.43	9.45	5.39	5.00	1.1	0.73	1.33	9.89	9.22	6.17	3.67	18.2
1986	1.56	3.95	10.76	9.22	0.28	6.00	15.0	0.85	3.83	11.70	1.04	7.72	3.70	29.3

Note: BPS = border price (per kilogram) in US dollars. BP = border price (per kilogram). EDR = export, duty rate (percent). NBP = after-duty border price in rupees. PPR = producer price in rupees. COP = cost of production in rupees. GPM = gross profit margin (percent).

a. The difference between NBP and PPR represents trade and transport margin.

b. $GPM = [(PPR - COP)/COP] \times 100$.

Source: Compiled using data from Central Bank of Ceylon, *Annual Report* (annual) and *Review of the Economy* (annual); Government of Sri Lanka, Department of Census and Statistics, *Statistical Abstract* (annual).

Table SA-20 Data Used for the Estimation of the Scott Growth Equation, 1950-89

<i>Year</i>	<i>G</i>	<i>S</i>	<i>L</i>
1950	—	0.099	—
1951	0.063	0.119	0.019
1952	0.041	0.142	0.024
1953	0.008	0.118	0.018
1954	0.014	0.097	0.213
1955	0.055	0.113	0.027
1956	-0.002	0.115	0.023
1957	0.011	0.119	0.010
1958	0.026	0.113	0.026
1959	0.009	0.159	0.047
1960	0.039	0.141	0.070
1961	0.014	0.137	0.030
1962	0.038	0.142	0.200
1963	0.016	0.147	-0.004
1964	0.046	0.142	-0.012
1965	0.024	0.131	0.089
1966	0.037	0.139	0.040
1967	0.044	0.149	0.014
1968	0.071	0.139	-0.011
1969	0.052	0.177	0.005
1970	0.036	0.177	0.034
1971	-0.018	0.156	0.040
1972	0.018	0.147	0.033
1973	0.030	0.138	-0.017
1974	0.023	0.130	0.056
1975	0.021	0.146	0.028
1976	0.027	0.166	0.012
1977	0.046	0.173	0.016
1978	0.082	0.210	0.035
1979	0.060	0.281	0.040
1980	0.055	0.346	—
1981	0.064	0.312	—
1982	0.041	0.320	—
1983	0.042	0.310	—
1984	0.053	0.282	—
1985	0.064	0.259	—
1986	0.041	0.259	—
1987	0.014	0.257	—
1988	0.027	0.245	—
1989	0.022	0.238	—

Note: G = GDP growth (growth of nonresidential business, defined as total GDP less value added in following GDP categories: (a) ownership of dwelling, (b) public administration and defense, and (c) other services). S = rate of investment (gross domestic fixed capital formation as a ratio of GDP). L = growth of employment.

Source: L series was constructed from data in Snodgrass (1966), for the period 1950-60, and Hallett (1981); G and S series are based on data from Central Bank of Ceylon, *Annual Report* (annual). G and L are logarithmic differences of the relevant series. S has been estimated using current-price data.

Table SA-21 Money Supply, 1960-85 (millions of rupees)

Year	Currency (1)	Demand deposits (2)	M(1) (3)=(1)+(2)	Time and savings deposits at commercial banks (5)	M(2) (5)=(3)+(4)	Time and savings deposits at other savings institutes (6)	M(3) (7)=(5)+(4)	Time and savings deposits as a percentage of M3 (6)+(5)=(7)
1960	595.3	613.6	1,208.9	363.6	1,259.7	451.1	1,710.8	29
1961	692.2	596.4	1,288.6	354.4	1,643.0	459.9	2,102.9	39
1962	716.6	630.0	1,342.7	404.6	1,747.3	470.3	2,217.6	39
1963	828.4	677.7	1,506.0	468.0	1,974.0	487.1	2,461.1	39
1964	853.0	768.8	1,621.8	520.2	2,142.0	521.3	2,663.3	39
1965	901.4	814.3	1,715.7	567.1	2,282.8	555.5	2,838.3	40
1966	882.5	776.4	1,658.9	584.5	2,243.4	586.1	2,829.5	41
1967	979.9	827.7	1,807.6	686.6	2,494.2	622.5	3,116.7	42
1968	1,066.2	847.0	1,913.2	811.2	2,724.4	664.9	3,389.3	44
1969	1,038.9	799.7	1,883.1	969.3	2,852.4	674.8	3,527.2	47
1970	935.1	1,031.5	1,966.6	1,148.2	3,114.8	780.7	3,895.6	50
1971	115.3	1,033.8	2,149.1	1,235.8	3,434.9	992.5	4,357.4	51
1972	1,202.3	1,278.8	2,481.1	1,493.1	3,974.2	1,032.8	5,007.0	50
1973	1,406.7	1,341.0	2,777.7	1,376.2	4,153.9	1,241.4	5,395.3	52
1974	1,539.3	1,406.3	2,945.6	1,622.5	4,568.1	1,512.6	6,080.7	52
1975	1,609.8	1,478.4	3,088.1	1,668.9	4,757.0	1,769.7	6,526.7	53
1976	2,080.5	2,085.1	4,165.6	2,155.3	6,320.9	2,101.4	8,422.3	51
1977	2,791.7	2,574.2	5,365.8	3,441.5	8,807.3	2,959.5	11,402.8	53
1978	3,015.5	2,920.8	5,936.4	5,025.5	10,961.9	3,165.9	14,127.8	58
1979	3,774.2	3,895.1	7,669.3	7,388.3	15,057.6	4,286.6	19,344.2	60
1980	4,180.8	5,247.3	9,428.2	10,432.0	19,860.2	4,953.1	24,813.3	62
1981	4,822.9	5,201.5	10,024.4	14,422.4	24,446.8	5,439.3	29,886.1	66
1982	5,987.7	5,772.1	11,759.8	18,750.1	30,509.0	7,673.4	38,183.3	69
1983	7,200.1	7,547.8	14,747.9	22,509.0	37,256.9	9,472.3	46,729.2	68
1984	8,560.9	8,262.9	16,823.8	26,603.6	43,427.4	11,642.5	55,069.9	69
1985	9,815.5	8,945.5	18,761.0	29,647.9	48,408.9	13,267.6	61,676.5	70

Source: Central Bank of Ceylon, *Annual Report* (annual).

Notes

Chapter Notes

1. For a concise history of Sri Lanka, see de Silva (1981).
2. The standard reference on the plantation industries is Snodgrass (1966).
3. For more details on the FEECS and related trade policy reform measures, see Cuthbertson and Athukorala (1990).
4. The history of the Mahaweli project goes back to the early 1950s. It is said that the project was initially conceived by Don Steven Senanayaka as a means of rejuvenating the North-Central province, the heartland of the ancient irrigation-based civilization of Sri Lanka. The feasibility of the project was first considered by a joint Sri Lanka/United States mission in 1958 and explored further by the World Bank in 1961 (Levy 1985). A master plan, which detailed a three-phase, thirty-year program of implementation was prepared by a joint UNDP/FAO team between 1965 and 1968. This program was targeted at irrigating 900,000 acres of land for over half a million people and also at developing fifteen multipurpose projects, four transbasin diversion canals, and several power stations with a total capacity of 500 megawatts. The cost of the project (at 1968 market prices) was estimated at 6,700 million rupees (Mendis 1973).
5. These policy reforms have been the subject of substantial research. See Athukorala (1986), Rajapatirana (1988), Lal and Rajapatirana (1989), Athukorala and Rajapatirana (1990), and Cuthbertson and Athukorala (1990).
6. Relations between Sri Lanka and India had already been strained by Sri Lanka's alleged decision to provide limited naval facilities for the United States at Trincomalee, a large natural harbor on the east coast, the establishment of close links with China and Pakistan, and the permission granted to Israel to establish a quasi-diplomatic presence in Colombo.
7. Data used in this paragraph are from Central Bank of Ceylon *Annual Report—1990*.
8. This increase is even sharper (from 42–48 percent to 65 percent) when shares are estimated using current price data.
9. For more detailed discussions of government intervention in the rice market, see Edirisinghe (1975), Gavan and Chandrasekara (1979), and Gunawardana (1989).
10. For details on this topic, see Gunasekara (1962), Karunatilake (1986), and Hettiarachchi (1986).
11. By statute, the NSB is required to invest at least 60 percent of its deposits in government securities. Since its inception it has always surpassed this norm, usually investing about 95–97 percent of those deposits. Under the EPF charter, the Monetary Board of the Central Bank decides which investment practices can be used by the EPF. In reality, over 95 percent of the accumulated funds are invested in government securities.
12. Khatkhate (1982) provides an anatomy of financial retardation in the Sri Lankan economy during this period.
13. The nature and reliability of these indices are discussed in appendix II.
14. For a useful account of the growth of the tourist industry, see Central Bank of Ceylon *Annual Report—1979*.

15. Given the high degree of import-intensity of garments and other newly emerging manufactured exports, the use of export shares estimated in gross terms for analysis of the changing export pattern exaggerates the reduction in the importance of primary exports in the export structure and overall export growth. An analysis of the growth and structure of exports based on net export series (derived using input-output tables) shows that the combined share of traditional agricultural exports in total net export earnings declined between 1977 and 1985 by only 14 percent (94 percent to 81 percent) as against a 33 percent decline (86 percent to 59 percent) observed in gross terms. The average annual growth rates of exports during 1977–85 in gross and net terms were 11 percent and 7 percent, respectively (Athukorala and Bandara 1989).
16. Imported rice and wheat flour contributed to more than half the domestic cereal supply in these years (Kappagoda and Paine 1981).
17. Alternative explanations of this savings behavior include Ricardian equivalence (private agents respond to government austerity with lower savings in the expectation of lower taxes in the future) or the simple Keynesian response (lower savings in response to lower current income).
18. For a detailed account of the PSIP, see Karunatilake (1987).
19. The World Bank did not finance any of the big dams, but it financed the construction of the original diversion barrage (a barrage is a type of dam) across the Mahaweli River. It also financed the power distribution networks and the feeder canals and civil works needed to make use of the output of the dams.
20. When the terms of trade change is taken into account, real growth in 1979 was only 3.1 percent.
21. The rate at which the Central Bank grants advances to commercial banks for temporary liquidity purposes.
22. The real exchange rate, in the presence of factor specificity and labor market distortions, can behave in a manner that does not conform to the predictions of simpler models, and these results should be interpreted with care (Edwards 1988; Hazari, Jayasuriya, and Sgro, forthcoming).
23. Lal (1985) invokes the composite good theorem to justify his aggregation of the importables and exportables into a single composite good, tradables. Such an aggregation is valid only if the relative prices of the goods being aggregated remain constant. As Lal's analytical model focussed on the price and real exchange rate adjustments to capital flows, it was a useful simplification. However, its use in empirical analysis was not justified given the large change in the relative price of importables and exportables expressed in the terms of trade change.
24. The TOT was strongly (negatively) correlated with net capital inflows as well as government expenditure, which was another explanatory variable.
25. Comparisons of export volumes in this period with previous periods should be made with considerable caution because of the substantial changes in composition due, in particular, to the growth of manufactured exports.
26. The latter function could not be extended for the post-1982 period because the Central Bank ceased to publish a separate private investment series in 1983.
27. Quoted in Karunatilake (1987:405).
28. Analysis of the agriculture components of the projects indicates very low returns. For example, the cost of production of rice in the project areas has been well above world prices (Ekanayake 1987; World Bank 1986). A comprehensive evaluation of the Mahaweli scheme remains to be done, as available studies have focussed on the irrigation and power components separately. This has led to underestimation of some of the major infrastructural costs, since each assessment has imputed different (and higher) proportions of total costs to the other component. These suggest that, even if considerably higher values are placed on the outputs, the rates of return obtained in the available studies—low as they are—should be considered as being on the high side.
29. While most important agricultural products have been discriminated against by government policies, the rice sector has received a significantly high level of protection. Effective protection for rice has been estimated to be around 15 percent (Edirisinghe 1991b).
30. Some estimates put the extent of this damage closer to two-thirds of GDP (World Bank 1991).
31. For a formal demonstration of this argument, see Lipton and Sachs (1990).

32. In the context of the intertemporal tradeoff involved, recall that a significant part of the budget deficit was financed by an implicit tax (via low interest rates) on the savings of wage earners held in the Employees' Provident Fund.

Appendix I Notes

1. On the basis of his experience from attempting to estimate his growth equation using time-series data for the United Kingdom and the United States, Scott notes that cyclical influences tend to reduce the degree of the overall fit of estimates based on annual observation much more than those based on period averages.
2. For useful surveys of this literature, see Mikesell and Zinser (1973); Fry (1988).
3. Of the explanatory variables discussed where, FIR and FS are not included in the financial saving function for obvious reasons.
4. The Central Bank data series on private investment stops in 1983.
5. Sophisticated econometric analysis of supply response of rubber and tea which addresses some of the complexities of modelling perennial crop supply responses is reported by Hartley, Nerlove, and Peters (1987) and Akiyama and Trivedi (1987). The focus of their analyses are different from ours and, due to time and data constraints, no attempt was made to adapt their approaches in our study. But their supply price elasticity estimates confirm our general conclusions. Further, it should be noted that they obtain quite low long-run elasticities; this may be partly due to the acute uncertainties that faced tea and rubber producers for a very long time.

Appendix II Notes

1. For further details on the socioeconomic data structure of Sri Lanka, see Karunatilake (1980 and 1984), Shourie (1974), Pyatt and Row (1977), and Hallett (1981).
2. See Savundranayagam (1983), and Central Bank of Ceylon, *Review of the Economy* (1978:22-24, and 1983:11-12) for details.
3. See Shourie (1974) for a revealing discussion on the deflator problem of Sri Lankan national accounts.
4. For a detailed discussion of these indices, see Khatkhate (1978).

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