III. Policies and Measures

22. Throughout 1952 the Central Bank judged that the dominant economic problem was the rapid fall of Ceylon's external assets, and that all necessary steps must be taken to make the country live within its means. The Bank believed this could be done by following sound monetary and fiscal policies. It did not favour the tightening of quantitative restrictions.

23. The Bank recognised that falling export income and higher import prices would have caused some loss of external assets even in the absence of credit expansion. When export prices fall it takes some time for the consuming public to adjust their spending to their lower incomes. The core of the problem was that monetary and fiscal policies were creating so much domestic purchasing power that the Ceylon economy could not return to equilibrium with the outside world. Imports remained excessive ; the general level of consumption in Ceylon was too high. The situation required a contraction of domestic purchasing power that would cut consumption and reduce imports even of essential goods.

24. For the balance of payments deficit was so wide that there was no alternative but to reduce the demand for essential imports. It would not have been enough to cut what are commonly regarded as luxury and non-essential imports. They were not being imported in sufficient volume to affect the payments gap significantly.

25. In such a situation it is tempting to resort to quantitative restrictions. But restricting imports quantitatively does not attack the core of the problem, the excessive volume of domestic purchasing power. Moreover, import and exchange controls, to be really effective, would have to cut deeply into essential imports and other foreign spending. And if they did so, price control and rationing of essential consumer goods would be necessary. Otherwise, the cost of living and costs of production would rise, adversely affecting the competitiveness of Ceylon's exports; and large windfall gains would go to importers at the expense of consumers.

26. Though it would not solve the balance of payments problem, the curbing of luxury and non-essential imports by making them bear a heavy burden of duties may nevertheless be good policy for a developing economy for other reasons. It can preserve for development a fringe of foreign assets that would otherwise be dissipated.

27. An underlying difficulty in 1952 was that the country as a whole had become accustomed during the Korean War boom to a level and pattern of expenditure that it could not afford to maintain after the boom subsided. Also, on the political side, there was the untimely death of the first Prime Minister, followed by a general election and the formation of a new Cabinet. A new Government took up its task in the midst of an economic situation that was deteriorating.

28. *The Budget.*—In 1951, of all factors within the control of the monetary and fiscal authorities, the most important factor contributing to stability was the achievement by Government of a virtually balanced budget. In 1952, of such factors, the most important contributing to the loss of external assets was the heavy budget deficit.

29. The Bank does not condemn deficit financing as such. A basic reason for having external assets is that they can be used as a cushion to soften the impact upon the public of sharp drops in export prices and incomes. In a country like Ceylon, to which foreign trade is very important, monetary and fiscal policy can be consciously used for this purpose. When export prices and incomes drop, it may be helpful to permit a budget deficit to grow. Under such conditions, however, two critical decisions must be made, those determining: (*a*) the safe limit of the deficit, and (*b*) the proper purposes for which the deficit ought to be incurred.

30. With regard to (*a*) the safe limit to budget deficits in Ceylon is narrow. As a general principle the limit of deficit financing is wider the more domestic output, and the less the volume of imports, may be expected to respond to any increase in demand generated by the deficit. By this test the limit for Ceylon is very narrow indeed. For the experience of 1952 suggests that, beyond a narrow limit, nearly all of any increase in the deficit is spent on imports. Certainly, in a period of adjustment to a collapsing boom the deficit cannot be greatly in excess of the external assets that the monetary and fiscal authorities are prepared to lose. During the calendar year 1952 the budget deficit, at Rs. 314 million, ran well beyond the safe limit.

31. As for (*b*) it has already been indicated that the deficit was used to finance present consumption at the expense of the development that Ceylon vitally needs. The most important element of Government consumption expenditure was food subsidies.

32. *Subsidies.*—The 1950 and 1951 Annual Reports argued the case against excessive subsidies at length. The concern expressed in those Reports has been justified. " Subsidies tend to throw entirely upon the Government the burden of paying for the rising cost of essential commodities." " As world rice prices rose, the price of rationed rice remained the same. To raise it required a difficult political decision. Government was thus faced with the necessity of supplying a fixed amount of rice to the public at a price that was steadily becoming more and more unreal." As subsidies grow, " Government may be forced into the most unenviable position of having to decide to forgo much needed development expenditure rather than raise the price of rationed rice."*

33. The financial burden of subsidies and their other harmful effects were more serious in 1952 than in any previous year. For Government was caught in a squeeze: on the one side, falling revenues due to the decline in export prices and incomes; on the other a rapidly growing subsidy bill due to the sharp rise in the world price of rice. As rice became a more and more expensive food the cost to the country of maintaining its consumption rather than of encouraging the use of cheaper substitutes became more and more apparent. At one time during the year rice costing more than Re. 1 a measure was being sold at 25 cents. Even in countries exporting rice, consumers paid almost double what the Ceylon consumer paid for rationed rice.

---

* The first quotation is from the 1950 Annual Report; the second and third are from the 1951 Annual Report.

34. The economic case for subsidies varies according as they are financed.

35. The Bank considers that they could be best defended during the boom. The Government was then able to meet the subsidy bill, and even all development expenditures, out of taxation without having to cut other expenditures. Producers of export commodities who were receiving windfall incomes had a portion of those windfalls taxed away (by heavy export duties) and distributed to the majority of the consuming public whose incomes had not increased so much. Under such circumstances, subsidies are a transfer payment from the high income groups to all consumers of subsidized rice. Although subsidies raised the level of consumption, the country as a whole still lived within its means. Under even these most favourable conditions, however, it is arguable that the long run interest of the country would have been better served by restraining the increase in consumption, so husbanding more foreign assets for economic development.

36. In 1952 subsidies were not paid for by taxes but by newly created money. In other words, if subsidies had been eliminated, the budget deficit, and the expansion of credit, could have been reduced correspondingly and external assets would not have been used to support a level of consumption that the country could not afford.

37. Subsidies financed by expanding bank credit are maintaining the level of consumption in the country at a point where it can be sustained only by running down foreign assets. In the absence of another export boom there is no alternative but to reduce this level of consumption. The issue is clear : not whether to reduce consumption, but when to reduce it—while the country still has external assets that can be used for development, or after such assets are exhausted.

38. *Government Measures—The Eight-Point Austerity Programme.*—Government was alive to the fact that the budget deficit, and more particularly the food subsidy bill, were getting out of hand. By July when the 1952-53 budget was presented, the subsidy bill was running at a rate of Rs. 300 million per year, or about one-third of estimated revenue. In the budget, food subsidies were put at Rs. 161 million and Government subsequently took measures to bring actual expenditures within this amount. It concluded two agreements with China, one a short-term rice purchase agreement and the other a long-term rice-rubber trade agreement (pages 12-13), which tapped a new and large supply of more moderately priced rice. Also, toward the end of the financial year Government adopted an Eight-Point Austerity Programme under which :

(*a*) the rice ration was reduced by one-quarter measure for all recipients, and

(*b*) the selling price of sugar, of which the Government was the sole supplier, was increased by 15 cents per pound.

39. By these measures Government made certain that the food subsidy bill for the financial year would remain within the Rs. 161 million voted by Parliament.

40. The other six points in the programme were designed to cut the budget deficit still further and to deal with the crisis in other ways :

(*c*) a surcharge of 10 per cent was imposed on existing import duties on less essential goods ;

(*d*) a surcharge of 10 per cent was imposed on assessed income tax, personal and company, for one year ;

(*e*) the betting tax was doubled, from 10 per cent to 20 per cent ;

(*f*) strict control of expenditure on non-urgent items in the budget estimates was introduced with the object of reducing total expenditure by approximately Rs. 100 million ;

(*g*) the guaranteed prices of locally produced foodstuffs were raised— paddy, from Rs. 9 to Rs. 12 per bushel ; maize, Rs. 7 to Rs. 7 ·50 ; kurakkan, Rs. 6 ·75 to Rs. 7 ; sorghum, Rs. 7 to Rs. 8 ;

(*h*) import control, which had been relaxed in 1950 as an anti-inflationary measure, was intensified with respect to dollar and continental European Payments Union countries.

41. Import control was intensified, partly because of exceptional purchases of dollar food. The new controls, however, implied only a small cut in total imports, since supplies excluded from restricted sources were available from other sources. Ceylon has continued to enjoy the benefits of substantial freedom from direct controls on imports.

42. By the beginning of 1953 it was already apparent that the Austerity Programme had not reduced the budget deficit sufficiently to stop the serious drain on external assets.

43. *Sale of Off-ration Rice.*—In April, 1951, the Government adopted the practice of selling unlimited quantities of imported rice outside the ration at cost price. The purpose was to check the rising cost of living by reducing the prevailing high price of " country " rice (the sale and purchase of which was completely free) to the level of the price of imported rice.

44. Early in 1952 in view of increasing difficulties in obtaining supplies the Government limited these sales to certain varieties of imported rice. By the middle of the year off-ration sales of imported rice had effectively ended.

45. The effects were several. Rice imports and rice consumption were less because no rice was brought in for off-ration sale. But the price of " country " rice rose both to the producer and to the consumer. By December the cost of living index was nearly four points higher than it would otherwise have been. The higher price of rice also stimulates domestic production.

46. The policy of keeping the price of domestic rice far above a world price that is already high raises the question of how far it is advisable to go in stimulating domestic rice production at the expense of the consumer. The Ceylon consumer was in the curious position of being able to buy his ration of imported rice at less than one-third the world price and having to pay far in excess of the world price for rice bought off the ration.

47. *Expansion of Central and Commercial Bank Credit to Government.*—The large budget deficit faced the Central Bank with the need for raising money on an unprecedented scale. This was at a time when visible savings in the form of savings deposits and savings certificates were gradually drying up. During 1952 there was an increase of only Rs. 28 million in visible savings in the form of savings deposits and certificates. The budget deficit for the same period is estimated at Rs. 314 million. There was no alternative but to expand bank credit on a scale which, considered in the light of the falling external assets, was far in excess of what would have been prudent.

48. Two loans, totalling Rs. 100 million, were opened in July: one of them, a 4–6 year loan at 2¼ per cent, was specifically designed to be attractive to commercial banks. In fact, commercial banks subscribed Rs. 25.5 million out of the total of Rs. 34.5 million subscribed to that loan. In addition, banks subscribed heavily to treasury bills during the year : the amount outstanding rose from Rs. 15 million to Rs. 100 million. The Central Bank also increased its holdings of Government securities. At the end of 1951 the Central Bank held only about Rs. 3 million of such securities ; by the end of 1952 it held almost Rs. 76 million. In addition, the Central Bank greatly increased its direct advances to Government. These advances totalled approximately Rs. 14 million at the end of 1951 ; they were Rs. 85 million at the end of 1952. The total credit expansion to the Government sector during the year was Rs. 217·1 million, of which Rs. 149·8 million was by the Central Bank.

49. *Open Market Operations.*—As indicated above, the Central Bank was obliged to engage in open market purchases from time to time, especially towards the end of the year. At no time during the year was there heavy selling pressure in the market ; on the other hand, market demand at existing yields gradually disappeared.

50. *Commercial Bank Credit to the Private Sector.*—Commercial bank credit to the private sector contracted during the year by approximately Rs. 20 million. The contraction was the result of the general decline of trade, not of the policy of the Central Bank.

51. On the other hand, because of its concern with the excessive expansion of credit to the Government sector the Bank did not actively encourage expansion of credit to the private sector. There was one exception of minor importance. In June the Bank changed its attitude toward the extension of credit for the purchase of shares or estates. The banks were informed that there was no objection to the resumption of their normal practices with respect to such lending provided they required the maintenance of a margin of at least 50 per cent of the market value of shares.

52. As reported in the 1951 Report the Bank in late 1951 altered its attitude toward the foreign balances of commercial banks. In January, 1952, forward exchange rates were increased, maximum working balances in sterling were fixed for each commercial bank, and the Central Bank thereafter refused to purchase sterling forward from any bank whose actual balance in sterling exceeded the working balance limit. The fall of approximately Rs. 88 million in the foreign exchange holdings

of the commercial banks between the end of January and the end of May, by which time every bank's sterling balances were finally drawn down below its working balance limit, gives a rough indication of the effectiveness of the policy. The repatriated balances were used to expand credit to the Government sector as well as to meet the loss of deposits suffered by the banks as a result of the adverse balance of payments.

53. *Interest Rates.*—Despite the large expansion of bank credit, the Central Bank did not raise its discount rate. There was also no significant change in the long-term rate of interest. Government paper of 21-26 years' maturity continued to be quoted in the market at a rate giving a yield a fraction under 3 per cent per annum. The short-term interest rate as reflected in the yield of Government securities below five years' maturity and the treasury bill rate rose. The latter went up from 0·4 per cent per annum at the beginning of the year to 0·92 per cent in August, 1952, at which level it stood for the rest of the year.

54. *Exchange Control.*—The Bank administers exchange control as agent of the Government. At the request of the Government, action was taken to tighten exchange control in September, 1952, thus reversing the policy of relaxation introduced a year earlier. With the continuing deterioration in the balance of payments, there had been a general expectation that exchange control would be tightened. The regulations that permitted remittances below a liberal exemption limit to be made without prior approval of the Exchange Control authorities were withdrawn in September, 1952, and lower exemption limits were fixed. Subsequently the limits were progressively revised downward and by the end of the year exchange for maintenance, travel, charity and other current purposes was considerably restricted.

IV. Basic Economic Data

55. *Foreign Trade.*—The 1952 foreign trade deficit was the largest in Ceylon's history. Imports in 1951 were a record Rs. 1,559 million. They rose still higher in 1952 to a new peak of Rs. 1,702 million.

56. The value of exports, which had reached the record level of Rs. 1,904 million in 1951, fell to Rs. 1,502 million in 1952. This was below even the 1950 figure.

57. The contrast of the Rs. 200 million deficit of 1952 with the regular surpluses of pre-war years and the very large surpluses of 1950 (Rs. 396 million) and 1951 (Rs. 345 million) emphasizes the sharp turn for the worse in Ceylon's trade fortunes.

58. As indicated previously (p. 4), the terms of trade for Ceylon fell from 101 in 1950 and 104 in 1951 to 75 in 1952. Save for the boom times of 1950 and 1951, Ceylon's terms of trade have been adverse in the post-war years as compared