I. Introduction

1. This, the fifth Annual Report of the Monetary Board of the Central Bank of Ceylon, is issued in accordance with section 35 of the Monetary Law Act, No. 58 of 1949. This section provides that within three months after the end of the financial year—that is, by March 31st—the Monetary Board shall submit to the Minister of Finance and shall publish an Annual Report on the condition of the Central Bank, a review of policies and measures adopted by the Monetary Board during the financial year, and an analysis of the economic and financial circumstances that prompted those policies and measures.

2. With effect from October 14th, 1954, Sir Arthur Ranasinha, Kt., C.M.G., C.B.E., was appointed Governor. In terms of section 8 of the Monetary Law Act Mr. R. N. Bond took his place on the Monetary Board as Acting Permanent Secretary to the Ministry of Finance, until relieved by Mr. L. J. de S. Seneviratne, who had been permanently appointed to the post of Permanent Secretary.

3. The Bank's financial year is the calendar year. The following report is concerned primarily with the year 1954.

II. The Economic and Financial Situation

4. In the year, 1954, Ceylon made a remarkable economic and financial recovery. The preceding year had ended with Ceylon's economy in an adverse disequilibrium with the outside world. External assets had been lost in that year to the amount of Rs. 230 million, and although an improvement in the terms of trade had occurred, the year had closed with a trade deficit of Rs. 40 million. But in 1954, the record was different. The terms of trade, which in a large measure determine the level of real income in Ceylon, were on the average 22 per cent higher than in 1953 ; also, for the first time in many years, the Government had an overall budget surplus in the financial year, 1953-54. These factors accounted in the main for a record trade surplus in 1954 of Rs. 412 million and a rise in external assets of Rs. 288 million.

5. The value of exports rose by Rs. 241 million to Rs. 1,809 million in 1954, and the value of imports fell by Rs. 211 million to Rs. 1,397 million.

6. The increase in export value was fortuitous, due mainly to a rise in tea prices. It may ordinarily have been expected that a rise in export values resulting in an increase in income may have led to an increase in expenditure, including expenditure in imports. But the circumstance that in the year under review Ceylon spent less on imports would appear to need some explanation. There is no doubt that in part at least the decline in expenditure on imports was occasioned by a general fall in the prices of imports, but there was also a decrease in the volume of imports below that in the previous year.

7. The diminution in volume was the more remarkable since Government by its budgetary operations had left in the hands of the private sector spendable income virtually at the same level as in 1953. For it ran in the calendar year, 1954,

a net cash operating surplus of Rs. 85 million as against a net cash operating deficit of Rs. 177 million in the previous year, while at the same time there was in 1954 an increase in export income of Rs. 241 million.

8. The fall in import volume indicates that the private sector did not expend any increase in real income on the consumption of imports, partly perhaps in reaction to the experience following the Korean boom in 1952 and 1953, but chiefly because of the reduction in Government expenditure in 1954, which, in combination with the increase in the value of tea exports, brought about a sectional redistribution of income within the economy in favour of those whose marginal propensity to save is regarded as high.

9. The increase in the value of tea exports in 1954 was greater than the increase in the value of total exports, the value of rubber and coconut exports having fallen. In local tea production (unlike in rubber and coconut production) small holdings account for a comparatively small proportion of the total output, and it is therefore evident that the greater benefit of the rise in tea prices accrued to large estate owners and companies, whose marginal propensity to save is high. And it may be observed that such increase in money savings as resulted from an increase in tea incomes would have consisted in part at least of deferred payments abroad in respect of distributable profits and dividends.

10. The Government closed its budgetary gap in 1953-54 by cutting down expenditure, chiefly on food subsidies. This reduction in expenditure affected most the incomes of those people whose marginal propensity to consume is greater than that of tea owners. The decrease in consumption caused by the reduction in Government expenditure must therefore have been greater than the increase in consumption due to the rise in the incomes of tea estate owners. Thus the sectional re-distribution of income in 1954 augmented private saving.

11. The increase in Government saving in 1954, as compared with the previous year, prevented the substantial increase in export value from having any appreciable expansionary effect on private money income. It also prevented money supply from expanding excessively. In addition, the private sector converted a part of its cash balances into Government securities and treasury bills previously held by the banking sector. As a result, although foreign banking assets rose by Rs. 341 million (including Rs. 63.3 million as net proceeds of the London Loan floated, in March, 1954), money supply expanded by only Rs. 130 ·3 million.

12. The moderate increase in the money supply had no inflationary consequences on the economy. The Colombo Consumers' Price Index was in fact 0 ·5 per cent lower than in 1953. One of the causes for the drop in this index was the average fall, of nearly 2 per cent, in prices in the domestic group of the index. A rise in these prices could be regarded as the best evidence of any inflationary pressure in the economy. The Colombo Consumers' Price Index would have been lower than it actually was in 1954, but for a rise (1 ·5 per cent) in the import group of the index ; this came about, in spite of the general fall in import prices in 1954, chiefly because of the reduction in the rice subsidy effected through the 1953-54

budget. Money wages in 1954 were substantially the same as in 1953 ; real wages were slightly higher.

13. The substantial balance of payments surplus, which increased the money supply, also increased the cash and near-cash reserves of the commercial banks. But the rise in commercial bank liquidity was relatively greater than the rise in money supply. Excess reserves of the commercial banks increased from Rs. 5·9 million at the end of December, 1953 to Rs. 33·2 million at the end of December, 1954 ; total liquid assets increased during the same period by Rs. 120 million, from Rs. 255·5 million to Rs. 375·5 million.

14. The increase in bank liquidity caused by the export boom in 1954 fortunately did not create a serious problem. By contrast, during the upward phase of the Korean war boom, in addition to the problem of commercial bank liquidity, there was both income and monetary inflation.

III. Policies and Measures

15. It may perhaps be worthwhile to review the experience of the period 1950 to 1954, which in Ceylon witnessed a boom, recession and recovery, in order to consider what lessons might be drawn from it in regard to fiscal and monetary policies.

16. Over the period 1950 and 1951, though external assets increased by only Rs. 252 million, the money supply expanded by as much as Rs. 357 million. The rise in external assets represented wholly an increase in savings by the private sector. It was brought about by a greater rise in income than in expenditure, rather than by a genuine increase in thrift. The vastly greater increase in the money supply than in external assets was principally the result of an overall budget deficit financed mainly through credit creation. The Government not only ran a deficit during the height of the Korean boom, but also committed itself to increased expenditure in future years.

17. With the collapse of the commodity boom, incomes shrank but the private sector did not reduce its expenditure. On the contrary, it actually increased its expenditure, by drawing down the money savings accumulated in 1950 and 1951. This process would ordinarily have ended with the exhaustion of money savings. But in 1952 and 1953, Government protracted the process by itself running, for reasons which seemed compelling from its own standpoint, a budget deficit largely sustained by inflationary borrowing. Because of this deficit, money supply was held at a high level despite excessive expenditure on imports and the resulting drain on external reserves.

18. By the middle of 1953, Ceylon's external assets had reached such a low point, that it was becoming increasingly evident that the only way to save the currency was to cut down the budget deficit. Measures adopted by the Government towards the end of the financial year 1951-52, had proved inadequate. But the budget for 1953-54 brought about a substantial improvement in Government finances, chiefly as a result of a sharp reduction in expenditure. This improvement led to a gradual decline in negative saving on the part of the private sector also, for