I. ECONOMIC PROBLEMS AND POLICIES—1960

(a) Introduction

In 1960, Ceylon's Gross National Product rose by 3·7 per cent in real terms. This is faster than the rate at which population is estimated to have increased and represents, therefore, a modest improvement in real product per person. Yet, in the monetary field the year 1960 was one of crisis. As in the years immediately preceding, Ceylon's total outlay on consumption and investment exceeded her National product. In the Process, her external reserves continued to fall rapidly. By 1960, the decline in external reserves had gone so far that corrective measures became imperative. From August 1960, onwards, following the formation of the new government, a series of such measures was introduced. These measures highlight Ceylon's experience in 1960 in the monetary and financial field.

It would be misleading, however, to view the year 1960 in isolation. It belongs essentially to a phase which commenced some years earlier. The chief feature of this phase was a succession of markedly expansionist budgets which led to a swelling of the domestic demand for goods and services. In the absence of a comparable increase in domestic production, this additional demand was largely met through higher imports. The availability of sizeable external reserves made these imports possible.

During the greater part of this period Ceylon's terms of trade, traditionally the chief determinant of changes in external reserves, were relatively stable or even mildly favourable. For a time, in fact, there emerged a situation, perhaps without precedent in earlier history, where an improvement in the terms of trade was accompanied by a continued decline in external reserves. In the course of 1960, however, the terms of trade themselves began to deteriorate with a fall in export prices.

In a sense, the year 1960 marks the culmination of the phase. By the end of the year Ceylon's external reserves were no longer adequate to finance a sustained and sizeable flow of excess imports. Henceforth total imports must bear a closer relationship to Ceylon's current earnings abroad as supplemented by external borrowing. It will hardly be possible, in the future, for any additional demand, generated by expansionist budgets, to be satisfied through imports. In the past, the level of domestic prices and costs were protected against the expansion in domestic demand since imports were possible to meet this demand. In the new situation this protection would be largely removed.

In 1960 the problems confronting monetary and fiscal policy were twofold. First the depletion of external reserves made necessary effective action to reduce imports. Second, attention had now to be paid to the repercussions of the reduction of imports on the national economy. These twin considerations guided the choice of measures. However, in 1960 the goal of a reduction of imports was naturally the more immediate.

The major factors underlying these developments, as they have emerged in recent years, are analysed in greater detail in the remainder of this Part. The response of monetary and fiscal policy to the developing situation is also described.

A factual and statistical account of the pattern of activity in the Ceylon economy during 1960 will be found in Part II.

(b) The Growth Trends in the Ceylon Economy

The rise in Ceylon's Gross Domestic Product in 1960 was in continuation of a trend which has been in existence for sometime. It reflects the gradual expansion that has been taking place in the productive capacity of the Ceylon economy. Over the years 1948 to 1960, for example, the average annual rate of growth in Gross Domestic Product at constant prices is estimated to have been 3·5 per cent. On account of the high rate of population growth, however, the improvement in Gross Domestic Product per capita has been less. On the basis of an average rate of population increase of 2·6 per cent over the same period, the annual rise in G.D.P. per capita averages 0·9 per cent. In other words, the total output of the Ceylon economy had risen faster than population and made possible an improvement in average income per head.

This performance cannot, however, for several reasons, be considered satisfactory.

The improvement in Gross Domestic Product, is in the context of rapid population growth, itself modest. Ceylon requires a substantially higher rate of growth in G.D.P. if she is to achieve a significant improvement in standards of living. The average annual rate of growth of G.D.P. per capita of 0·9 per cent actually achieved in the period 1948–60 compares unfavourably with the rate of 2·9 per cent envisaged in Ceylon's Ten-Year Plan for the period 1957–1968. The need for a more rapid rate of growth is particularly urgent in the context of the employment situation. Ceylon's workforce is expanding rapidly. Though no accurate data are available there are ample indications that the rise in employment opportunities has fallen short of the increase in the workforce.

Further, the growth in Ceylon's Gross Domestic Product has not been accompanied by significant structural changes in the economy. Thus, at present estimates, the relative shares of agricultural production (including exports) and services in the Gross Domestic Product were practically the same in 1960 as in 1948. In 1948 the shares of agricultural production and of services were approximately 62 per cent and 33 per cent respectively ; in 1960 they were 61 per cent and 33 per cent. The relative share of manufacturing industry to the total Gross Domestic Product, at constant prices, rose mildly from 5·0 per cent in 1948 to 5·6 per cent in 1960. But the absolute contribution of industry to the rise in total product has remained small. In fact, in absolute terms, it is the contribution of tea to the increase in Gross Domestic Product that has been notable. Ceylon's Gross Domestic Product at constant prices is estimated to have increased by Rs. 2,046 million between 1948 and 1960. Rs. 506 million, or 25 per cent of this total, represents an increase in tea production. This increase in tea output was due primarily to a raising of yields through the greater use of fertilizers.

Another unsatisfactory aspect of the Ceylon economy concerns the use which Ceylon has made of the increase in its real income. Where standards of living are low and the average consumption level cannot easily be reduced, investment magnitudes can best be raised by ploughing back a substantial part of the increment to income into investment. Ceylon, however, has utilised the additional resources available to her in recent years more for increasing consumption than for raising investment. Hence, of an estimated increase in real terms of Rs. 2,943 million in the total outlay on consumption and capital formation over the period 1948 to 1960, 83 per cent was devoted to consumption and only 17 per cent to domestic capital formation. Thus Ceylon has not adequately made use of the opportunity provided by a rising domestic product to strengthen the base for future expansion.

(c) The Monetary Expansion in Recent Years

In recent years despite the growth in domestic products Ceylon has experienced an adverse monetary and financial situation. During this period, Ceylon's total outlays on consumption and investment increased faster than her Gross National Product. This resulted in an adverse balance of payments and a fall in external reserves. Ceylon's monetary and financial situation in 1960 was dominated by these developments. It is important, therefore, to examine the causal factors of relevance to them and to assess the situation that had emerged by the end of 1960.

(i) *The Contribution of the Budget*

The chief instrument responsible for the imbalance between total outlays and total product has been the government budget. A series of mounting budget deficits contributed towards an expansion of total purchasing power and a rising demand for goods and services. As will be seen presently, the expansionist effect of bank credit to the private sector was of a secondary and relatively minor order.

The size of the overall cash deficit in the Government's budget over the financial years 1951/52 to 1959/60 is shown below :—

TABLE I—I

Government's Over-all Cash Deficit—1951/52–1959/60.

Rupees Million

Year	51/52	52/53	53/54	54/55	55/56	56/57	57/58	58/59	59/60
Overall cash deficit ..	—257 ·1	—231 ·9	+33 ·7	+127 ·6	—1 ·2	—194 ·4	—222 ·3	—413 ·4	—417 ·5

As seen here, overall cash deficits were experienced before 1953/54. In that and the following year there were overall surpluses; but significant deficits re-emerged from 1956/57 onwards. In 1958/59 there was a marked stepping up of the size of these deficits. They have since remained around these high levels.

The rising budget deficits reflect a continued expansion in total government spending. Over the years 1955–56 to 1959–60, government expenditures have been rising, on average, at an annual rate of 9·8 per cent. The corresponding rate of increase in Government revenue has, on the other hand, been only 2·8 per cent.

The expansion on Government expenditures cover both capital and current outlays. However, by far the greater part of the rise in total expenditures has been due to an increase in current outlays. The course of each of these categories in recent years is as follows :

TABLE I—2

Total Government Expenditure 1952/53—1959/60

Rupees Million

Year	52/53	53/54	54/55	55/56	56/57	57/58	58/59	59/60*
Current expenditure(1)	841	728	762	892	1,110	1,118	1,280	1,362
Capital expenditure	359	293	357	431	396	499	493	526
Total expenditure	1,200	1,021	1,119	1,323	1,506	1,617	1,773	1,888

Though capital expenditures have increased in absolute terms, they absorbed only the smaller share—25·6 per cent—of the rise in total expenditures between 1952/53 and 1959/60. The remaining 74·4 per cent was devoted to current expenditures. Whilst these trends in the pattern of government spending are an aspect of the relative expansion in consumption outlays in the economy as a whole, the rate of increase in Government consumption has been substantially greater than that of private consumption.

It is true that in the context of a country like Ceylon, there are always at work factors which impart a persistent pressure towards the raising of current expenditure. Higher payments on account of normal increments and pensions outlays constitute a virtually " built in " source of rising expenditures ; the growth of population and the urgency of social and other needs require a rising volume of governmental services ; capital outlays themselves involve a raising of current expenditures for the operation and maintenance of completed projects ; in addition, the very process of deficit financing results in a growing burden of service charges on the public debt on account of interest and allied payments. All these elements are reflected in the rising trend of current expenditures.

There are, nevertheless, three factors which have played a particularly important part since 1958/59. These were social service expenditures–particularly on health and education—which partly reflect the progressive increase in population ; higher wage rates ; and rice subsidies. The particularly sharp increase in current expenditures in 1958/59 was largely due to increased social service expenditure and transfer payments, mainly the food-subsidy. The high outlays in 1959/60, (and the provision for 1960/61) include an enhanced provision for food subsidies following the reduction in the price of rationed rice in April, 1960. The total food subsidy bill which was reduced from Rs. 131·6 million in 1950/51 to Rs. 12·5 million in 1953/54 increased thereafter once more to Rs. 105·5 million in 1956/57 and Rs. 193 million in 1959/60. Current outlays on education rose by Rs. 37·8 million and Rs. 38·9 million in 1958/59 and 1959/60 respectively.

There has also been a rising trend in the revenues of Government. Over the period 1952/53 to 1959/60, for example, revenues rose from Rs. 952·5 million to 1,403·8 million representing an increase of 47·4 per cent. Yet these increases were outstripped by the rise in total expenditure. Further, the pattern of revenue in recent years indicates certain limitations in Ceylon's revenue structure. Expansionist budgets generally result in an increase in national income in money terms ; given a responsive revenue system there should be related increases in accruals to Government.

(1) Includes the net payment on advance account activities. In years when they resulted in a net receipt, it has been ignored.

* Provisional

The structure of government revenue is such, however, that whilst revenues tend to respond adequately to increases in national income caused by a rise in export earnings, they are less responsive to increases, which occur through other causes. There are essentially two reasons for this. First, the export duty is an effective instrument for channelling to revenue, proportions of increases in national income caused by rising export earnings. Second, the income tax and other direct taxes of Government tend themselves to be more responsive to changes in export earnings than to other changes. However, where the increase in national income, whether through Government spending or other causes, is more widely distributed, there does not arise spontaneously, a relative increase in revenue through direct taxes. This is one of the limitations of the revenue structure. Whilst levels of government expenditures may rise independantly of a rise in export earnings, some of the major sources of revenue tend to be closely dependent on the level of these earnings. Revenues from import duties, however, constitute an exception. As outlays on imports are an important part of consumer spending, revenues from import duties tend to be more responsive to income increases originating from a variety of sources. This would also be true of revenues from sales taxes and excise duties.

The mounting budget deficits of the Government, had to be primarily financed out of borrowing—whether domestic or foreign—or the drawing down of accumulated cash balances. The manner of financing is itself of relevance to the inflationary impact of the deficits. Deficits financed out of foreign borrowing, for example, are non-inflationary to the extent that the corresponding accruals of foreign exchange enable additional supplies of imports. Again, borrowing from non-bank sources tends to be less inflationary than Bank borrowing or the running down of cash balances. The last two sources strengthen the basis for further credit expansion by the banking system.

In the recent period the deficits of Government have progressively exceeded the limits of external financing and of borrowing from non-bank sources. The use of cash balances and bank borrowing as a means of financing deficits has, therefore, increased. In fact, with the depletion of cash balances after 1958/59, borrowing from the banking system constituted the main instrument of deficit financing.

The table below depicts the method of financing of the budget deficits over the period 1956/57 to 1959/60.

TABLE I—3

Financing of the Deficit

Rupees Million

Year	1955–56	1956–57	1957–58	1958–59	1959–60
1. Financing from non-bank sources—					
(*a*) Administrative borrowing ..	—36 ·8	— 9 ·4	72 ·5	27 ·6	57 ·4
(*b*) Foreign borrowing..	5 ·2	18 ·6	23 ·7	35 ·5	29 ·3
(*c*) Domestic market borrowing from non-bank sources	26 ·6	39 ·3	18 ·2	109 ·4	83 ·8
2. Domestic borrowing from Banking System	17 ·2	126 ·9	60 ·3	179 ·3	241 ·1
3. Use of Government cash balances ..	—11 ·0	21 ·0	47 ·5	61 ·7	6 ·0
4. Net cash deficit	1 ·2	196 ·4	222 ·3	413 ·4	417 ·5
5. Use of counterpart funds				—52 ·5	4 ·0
Total (items 2, 3 and 5)	6 ·2	147 ·9	107 ·8	188 ·5	251 ·1

Some factors of relevance to the figures above merit comment. The first concerns borrowing from the banking system. Although in the two years 1958/59 and 1959/60 Government borrowing from the banking system amounted to Rs. 179·3 million and Rs. 241·0 million, commercial bank lending to Government was only of the order of Rs. 3·1 million and Rs. 1·7 million over each of these years. It was essentially the Central Bank that constituted the primary source of bank funds to Government. In 1958/59 and 1959/60 Central Bank advances to Government rose by Rs. 41·1 million and Rs. 40·1 million respectively. But, more significant, over the same years, the Central Bank's holdings of Government and Government guaranteed paper inclusive of Treasury Bills, rose by Rs. 135·7 million and Rs. 232·9 million.

The Treasury Bill was in fact, by far the most important medium of governmental borrowing from the banking system. The rise in the Treasury Bills issue in recent years is notable. The volume of Treasury Bills outstanding rose from Rs. 140 million in September, 1958 to Rs. 320 million in September, 1959 and Rs. 550 million in September, 1960. The chief contributor to Treasury Bills, was the Central Bank. During the course of the financial year 1959/60, the authorised limit on Treasury Bills was raised twice by Parliament—to Rs. 450 million in October, 1959 and Rs. 650 million in August, 1960.

Second, mention must be made of the growing importance of investments by the Employees' Provident Fund as a source of non-bank borrowing. In 1959/60 net investment in government paper by the fund increased to Rs. 49 million as against Rs. 5·5 million in 1958/59. This reflects the increased coverage of employees by the Fund from December, 1959.

Finally, there is the emergence of counterpart funds, arising out of transactions under the U.S. PL 480 Aid Scheme, as a potential item of relevance to the size of the deficits and their financing. Rupee payments made by Government for the purchase of rice and flour under this scheme are included in the total government outlays. To the extent that these payments accumulate in counterpart fund accounts, however, they do not contribute towards an expansion of the money supply. On the other hand, the drawing down of counterpart funds for the making of loans and payments of various kinds are expansionist in their effects.

(ii) *The Contribution of Bank Lending*

The budgetary policy of the Government had its repercussions on the commercial banks. Budgetary deficits, on account of their expansionist effects, tend to raise the cash and other liquid assets of the commercial banks. The capacity of the banks for credit creation is thereby strengthened. The deficits in the Balance of Payments on current account on the other hand, tend to weaken the liquidity position of the banks. It has, in fact been the usual experience of Ceylon that the Banks' liquid assets tend to fluctuate markedly with changes in the country's external balance—rising when the balance of payments is favourable and vice versa. Since 1958, however, despite large deficits in the Balance of Payments on current account bank liquidity has actually improved. The total liquid assets of the banks rose from a monthly average of Rs. 301 million in 1958 to Rs. 311 million in 1959 and Rs. 333 million in 1960. This improvement in bank liquidity, despite the Balance of Payments position, reflects the offsetting effects of the Government's budgetary deficits.

The rise in bank liquidity strengthened the base for credit expansion. However, as already shown, commercial bank lending to Government in recent years has not been significant. Credit granted by the commercial banks to the private sector, on the other hand, has increased continuously. The average monthly volumes of commercial bank credit outstanding to the private sector in each of the years since 1957 have been as follows :—

TABLE I—4

Commercial bank lending to the Private Sector

(Average of monthly figures)

Rupees Million

	1957	1958	Increase over previous year	1959	Increase over previous year	1960	Increase over previous year
Bills discounted	100	116	+16	119	+ 3	115	— 4
Loans and overdrafts ..	340	363	+23	395	+32	430	+35
Total domestic lending to private sector	440	479	+39	514	+35	545	+31

There are two considerations of significance to the rise in bank lending. First, there is evidence to suggest that the increase was substantially for consumption rather than for production purposes. This is shown by the figures below depicting the changes in bank lending over the two year period September, 1958 to September, 1960, classified according to the purposes for which loans were granted.

TABLE I—5

Changes in Bank lending classified by Purpose

Rupees Million

Period	September 1958 to September 1960
Purpose—	
(*a*) Commercial	+15 ·0
(*b*) Financial	+37 ·7
(*c*) Agricultural	— 2 ·5
(*d*) Industrial	— 4 ·4
(*e*) Consumption	+ 9 ·4
(*f*) Other	— 2 ·2
Total	+53 ·0

Lending for financial purposes which accounts for the biggest share of the total increase relate chiefly to loans to hire purchase companies which, in turn, financed largely the purchase of durable consumer goods. Moreover, the rise in lending for commercial purposes reflects an increase in loans for import rather than for export trading. During the period referred to above loans for import trading actually rose by Rs. 28 million whilst loans for export trading fell by Rs. 13 million.

The second consideration concerns the magnitude of total bank lending. Although bank lending to the private sector has increased, the size of this expansion, as reflected in the figures above, has been relatively small in comparison to the government's budgetary deficits. Thus, in 1959 or 1960 whilst the increase in total bank lending was Rs. 35 million and Rs. 31 million the budget deficit for the corresponding fiscal years were Rs. 413 million and Rs. 418 million. Hence, the role of the commercial banks in the monetary expansion in recent years has been a relatively minor one. Moreover, as mentioned before, the strenghthened capacity of the banks to extend credit was itself a reflection of the growing budgetary deficits. On the other hand, Ceylon's adverse external balance served to restrain the rise in bank credit.

(iii) *The Impact on Money Supply*

The successive increases in the budgetary deficits of the Government, and to a lesser extent the rise in bank credit, imparted a markedly expansionist effect on the country's money supply. The actual rise in the money supply was however, partly offset by net payments abroad on additional imports and by an increase in time and savings deposits. The effect of each of these factors on the money supply over the years 1957 to 1960 is shown below.

TABLE I—6

Money Supply

Rupees Million

	1957	1958	1959	1960
Total money supply	1,040 ·1	1,076 ·8	1,177 ·7	1,208 ·9
Net change over previous year	— 86 ·7	+ 36 ·6	+101 ·0	+ 31 ·1
Expansionist Factors				
(*a*) Financing of the budget deficit ..	+116 ·7	+ 99 ·6	+347 ·0	+260 ·2
(*b*) Commercial bank credit to private sector	+ 55 ·3	+ 53 ·4	+ 9 ·7	+ 31 ·5
(*c*) Other	—	+ 34 ·1	—	+ 1 ·4
Total	+172 ·0	+187 ·1	+356 ·7	+293 ·1
Contractive Factors				
(*a*) Change in external banking assets ..	—209 ·2	— 82 ·2	—195 ·0	—170 ·2
(*b*) Increase in time and savings deposits..	— 38 ·4	— 68 ·1	— 23 ·2	— 72 ·5
(*c*) Other	— 11 ·1	—	— 37 ·5	— 19 ·3
Total	—258 ·7	—150 ·3	—255 ·7	—262 ·0

It is clear from the figures above that the inflationary impact on the money supply of deficit financing in recent years was offset to a substantial extent by the running down of external reserves. Had Ceylon been unable to have recourse to this source there would clearly have been a very marked and rapid expansion in the total money supply. The magnitude of the expansionist factors depicted above provide an approximate measure of the possible increase.

By limiting the increase in the money supply, the drain in Ceylon's external reserves served to restrain the possible increase in domestic prices that might otherwise have taken place. Nevertheless, the fact that the money supply rose despite the running down of external reserves indicates that the expansionist influence of the budget deficit has not been totally absorbed in this way. The high money supply constitute a potential source of additional demand for goods and services and hence of continuing inflationary pressure on prices and costs.

The rise in the money supply was also accompanied by a significant change in its components. Total money supply comprises both currency and demand deposits held by the public. It has hitherto been the experience of Ceylon that when total

TABLE I—7

Components of the Money Supply

Rupees Million

End of period	Currency held by the Public	Demand Deposits held by the public	Total money supply	Currency as % of money supply
1957..	434 ·9	605 ·2	1,040 ·1	41 ·8
1958..	529 ·8	546 ·9	1,076 ·8	49 ·2
1959..	565 ·0	612 ·7	1,177 ·7	48 ·0
1960..	595 ·3	613 ·6	1,208 ·9	49 ·2

money supply rises the share of currency in the total tends to fall. Conversely, in periods of declining money supply the share of currency tends to rise. These fluctuations in relative shares were a reflection of the importance of changes in export earnings as a determinant of the money supply. Changes in export incomes tend to be less widely distributed over the community and hence affect bank deposits more than currency in circulation. Over the years 1957 to 1960, on the other hand, the relative changes in the components of the money supply have been in a different direction. Thus, although total money supply increased during this period the volume of currency in circulation increased faster than demand deposits. Consequently, the proportion of currency in the total money supply increased. This is illustrated in the table above.

The rise in the currency ratio(1) in the background of a rising money supply, suggests that the increases in money incomes, originating largely from the budgetary deficits of government, tended to be distributed more widely than increases originating in the export sector. An increased share of wages and of earnings of peasant cultivators would, for instance, result in an increase in currency rather than in demand deposits. An additional factor may also have influenced the rise in the currency ratio. This is an increased preference to hold liquid assets in the form of currency rather than bank deposits.

The rise in the money supply, despite the deflationary effects of the adverse balance of payments is, as mentioned, an indication of inflationary pressure on domestic prices. However, the fact that the increases in domestic prices in recent years has been relatively limited suggests that either domestic output has increased in proportion to the rise in money supply or that a part of the increased income has been held in liquid form instead of being spent on consumption. The holding of savings in liquid form, however, would imply that they are capable of being drawn in the future for purposes of consumption. To this extent these holdings would constitute a possible source of future pressures on domestic prices or on imports. They would represent a legacy from the monetary expansion of the recent past.

(1) During this period there was also a rise in the ratio of currency to total bank deposits held by the public, inclusive of time and savings deposits.

(iv) *The Impact on the Balance of Payments*

The main impact of expansionist finance, as already indicated, was on the balance of payments rather than on the money supply. The overall budgetary deficits of the government helped to swell the total of money incomes in the economy and hence increased the demand for goods and services. In view of consumption and production patterns in Ceylon, this demand in turn meant largely an additional demand for imports rather than for domestic goods. Ceylon's total outlays abroad rose above her current external receipts and this resulted in an adverse balance of payments position. The excess of payments was almost entirely financed by a running down of external assets.

It is important to note that during the last four years Ceylon's exports themselves were rising in value. There was a decline in export earnings in 1956 and 1957 after the ending of the tea boom of the previous years; but from 1958 onwards the value of Ceylon's exports have consistently increased. This was due to increases in prices or volumes or, on occassion, to a combination of both. The value of exports over this period and indices of prices and volumes are given below :—

TABLE 1—8

Total Exports (1948=100)

Year	Value (Rs. Mn.)	Volume Index	Price Index
1957	1,682	116	142
1958	1,711	123	139
1959	1,754	121	145
1960	1,832	127	145

As the figures above indicate Ceylon's balance of payments difficulties since 1957 were not due to unfavourable developments in the export sector. They were not due either to a rise in import prices. The index of import prices has been declining since 1957. In fact, Ceylon's terms of trade, *i.e.* the ratio of export to import prices, have improved over this period. The actual changes in these items were as follows :—

TABLE I—9

Indices of Import Prices and the Terms of Trade

(1948=100)

Year	Import price index	Terms of trade
1957	112	127
1958	103	135
1959	102	142
1960	102	142

The improvement in the terms of trade is of significance. Ceylon has rarely experienced a situation where her balance of payments has remained adverse despite a sustained improvement in her terms of trade. Normally, changes in the balance of payments tend to reflect changes in the external factors which influence Ceylon's export or imports. Thus, an improvement in the terms of trade usually leads to an improvement in the balance of payments and a rise in reserves. A deterioration in the terms of trade, on the other hand, generally results in a fall in reserves. Even the fall in external reserves during 1952 and 1953 was only due in part to the high volume of deficit financing prevailing at the time. It was also caused by a sharp deterioration in Ceylon's terms of trade following the collapse of the Korean boom. Hence, the experience of the period since 1957 has not been paralleled in the past.

It must be mentioned, however, that during the course of 1960, the favourable trend in the terms of trade was itself reversed. Although, for the year as a whole, there was no decline in the terms of trade, a deterioration set in during the latter part of the year. This was due primarily to falling prices for rubber and coconuts But, though these developments are of consequence to Ceylon's present and future problems, they played no part in the decline in external reserves that had been taking place over the greater part of the period.

The key factor, then, in the adverse balance of payments situation in recent years was the rise in the volume of imports. From 1957 to 1959 the index of the volume of imports in Ceylon increased by 13 per cent.* The increase in import volume was a direct consequence of the additional internal demand generated by the rising budget deficits. The course of the index of import volume was as follows :—

Year	Index of Import Volume
1957	150
1958	151
1959	169
1960	162

The fall in the index of volume in 1960 is partly due to the corrective measures taken in the latter half of the year. During most of the year, the volume of imports remained at high levels.

Until 1960, the rising volume of imports led, despite the fall in import prices to an increase in total import outlays. The rise in imports relative to exports constituted the main source of disequilibrium in the balance of payments.

Changes over the years 1957–1960 in the chief components of Ceylon's balance of payments account are summarised in Table I—10.

*It is possible that on account of shifts in the pattern of imports the index of import volume, being based on fixed weights, understates the actual increase in import volume over these years.

TABLE I—10

Balance of Payments for 1957–1960

Rupees Million

	1957	1958	1959	1960 (Prov.)
	Net	Net	Net	Net
1. Merchandise	+ 27·8	+ 7·6	— 81·1	— 94·3
2. Services	—183·5	—137·4	—115·3	—132·8
3. Donations	— 39·6	— 23·1	— 11·6	+ 17·4
4. Current account balance	—195·3	—152·9	—208·0	—209·7
5. Private capital	— 38·4	— 4·0	+ 1·7	— 2·6
6. Official capital	+ 15·9	+ 26·1	+ 23·4	+ 6·5
7. Change in foreign reserves (including bilateral payments balances)	+210·8	+156·3	+177·0	+192·9
8. Errors and omissions	+ 7·0	— 25·5	+ 5·9	+ 12·9

Note: In item 7 a plus sign indicates a decline in reserves.

The figures above indicate the magnitude of the growing balance of payments problem faced by Ceylon. The course of the balance of merchandise trade is particularly significant. Ceylon normally experiences a recurring deficit on the service and other invisible items in the current account balance. On the other hand, Ceylon's balance of merchandise trade is usually in surplus. When this surplus more than offsets the deficit in invisible items, external reserves tend to rise. During 1959 and 1960, however, the increase in imports was so rapid that the surplus on merchandise trade was replaced by an actual deficit. This result was particularly striking, since during these years total earnings from exports actually increased. It vividly illustrates the extent of the monetary and financial disequilibrium in Ceylon's economy.

It was Ceylon's external reserves, which had, in the last analysis, to bear the impact of all these developments. Fortunately, by 1956 these reserves had been at a relatively high level. The broad history of Ceylon's external reserves may be briefly outlined. Built up during the second world war, the reserves were drawn down in the immediate post-war years. During 1950 and 1951 they were replenished again, but substantially reduced in the years that followed on account of the collapse of the Korean boom and the budgetary deficits of the government. Since 1954 with stringent corrective measures and a rise in the price of tea, they were augmented once more. By the end of 1956 they stood at Rs. 1,179 million—about the same as the heights attained during the Korean boom.

The decline in external reserves since 1956 is depicted below :—

TABLE I—11

External Assets of Ceylon

Rupees Million

End of period	Total	Change between periods	External Assets as % of year's import payments*
1956	1,179		61
1957	943	—236	44
1958	883	— 60	42
1959	689	—195	30
1960	481	—208	21

*Including invisibles.

Between 1956 and 1960 Ceylon lost Rs. 698·0 million of her external reserves—a fall of 59·2 per cent. Since 1958, the rate of decline in these reserves was itself increasing rapidly. By 1960, there was little to suggest that, outside of deliberate action, the trend would be reversed. The main contributory factor, the budget deficit, was expanding in volume from year to year, and swelling the inflationary pressure on imports. Moreover, by 1960, the buoyancy in export earnings was itself departing. It was evident that the level of external reserves was so low that it could no longer serve to cushion the monetary expansion.

There were also significant changes in the composition and liquidity pattern of the external reserves, the total of external assets include the holdings of Government, Government Agencies and Institutions, the Central Bank and the commercial banks. The main impact of the decline in reserves was on the holdings of the banking system—particularly those of the Central Bank. The external assets[1] held by the Central Bank which stood at Rs. 745 million or 63·2 per cent of the total at the end of 1956 declined to Rs. 173 million or 36·0 per cent of the total by the end of 1960.

Accompanying the change in composition was a change in the liquidity pattern of these reserves. Thus at the end of 1956, for example, the Central Bank's cash balances abroad, including Treasury Bills and bills discounted, amounted to Rs. 544 million and formed 73·8 per cent of the Central Bank's International Reserve[2]. On the same date holdings of foreign government securities amounted to Rs. 193 million forming 26·2 per cent of the Reserve. By the end of 1960, however, cash balances abroad, as defined here, had declined to Rs. 95 million and represented only 50 per cent of the international reserve. The balance 50 per cent consisted of holdings of foreign government securities of a total value of Rs. 95 million. These figures illustrate further the nature and magnitude of the problem concerning Ceylon's external reserves.

(v) *The Impact on the Domestic Price Level*

It remains now to assess the impact of the monetary expansion on the domestic price level. The impact on prices of a rapid rise in demand would depend on the response of supply. Where the increase in supply is less than proportionate to the rise in demand prices will tend to move upwards. The supply of goods and services comprises both domestic production and imports. In Ceylon, the share of imports in the pattern of consumption and investment is substantial.

This fact is of particular significance to the response of supply. As long as imports are relatively free from restrictive controls, and there exists the means of paying for them, the supply of imports would tend to increase in response to a rise in demand. This implies that the level of prices—in so far as it relates to imported goods—will be relatively unaffected by the expansion in demand. It would reflect largely the movements in price levels prevailing abroad. The impact of the rise in demand would be different for domestically produced goods for which there are generally no imported substitutes. Here, the effect on prices will depend on the increase in domestic output. Where production cannot increase rapidly prices would rise, and the inflationary consequences of the monetary expansion would become more readily evident.

There is no accurate measure of the impact of the monetary expansion on the general level of prices in Ceylon. No indices exist of the movements in retail or wholesale prices. The best available approximation is the Colombo-Consumers' Price Index which is based on items entering into the pattern of working class consumption in Colombo. This is not fully representative of the movements in general retail prices, not only because of its limited coverage but also because of the importance of subsidised items in the working class budget. Nevertheless, despite these limitations, movements in the consumers' price index shown below provide some indication of the course of retail prices in Ceylon :—

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(1) According to books abroad at face value.

(2) According to local books at cost or face value, whichever is less.

TABLE I—12

Index of Consumer Prices

(1952=100)

	All items	Domestic Group	Import Group	Export Group
1956	100 ·2	100 ·0	99 ·0	115 ·1
1957	102 ·8	104 ·9	98 ·1	126 ·8
1958	105 ·0	109 ·2	97 ·0	135 ·0
1959	105 ·2	108 ·0	97 ·1	153 ·1
1960	103 ·5	108 ·9	93 ·7	138 ·2

Weights: Domestic group 51%; Import group 44%; Export group 5%.

These figures suggest that despite the substantial monetary expansion in recent years the increase in the price level has been remarkably moderate. This is primarily a reflection of the fact that the rise in demand has been generally met through additional imports. The falling trend in the index for the import group is due to the decline in import prices referred to earlier and, more recently, to the reduction in the price of subsidised rice. The rising trend in the index for the domestic group is, however, significant. It indicates that in those fields where there are no imported substitutes for domestic production, supply may not always have kept pace with the rise in demand and prices may consequently have increased. The course of the index for the export group reflects movements in the world prices for Ceylon's export products. The weightage for this group in the index for all items, is, however, small.

The conclusion that emerges is important. Ceylon has, in recent years, avoided a sharp inflation in the level of domestic prices on account of its ability to satisfy the rise in demand out of additional imports. She has, in effect, protected the domestic price level at the expense of her external reserves. The absence of a price inflation has in turn restrained a corresponding inflation in wages and costs. This situation, however, could only prevail as long as additional imports flow in freely. Once imports need to be restricted in order to stem the drain in external reserves the position would alter basically. The supply of imports would no longer respond adequately to meet the sustained demand. Unless, therefore, the monetary expansion is itself curtailed, or the level of domestic production is rapidly and adequately increased, there will be persistent and serious pressures on the level of prices. In this event, a new phase of rising prices and costs will inevitably emerge.

(d) Policies and Measures

The present section outlines the policies and measures adopted, both by the Government and the Central Bank, during 1960 to meet the grave monetary and financial situation described in the preceding survey.

The Annual Report for 1959, as well as reports for previous years, have emphasised that the scope for effective monetary action is severely limited when the chief cause of imbalance in the economy is the Government budget. In this situation it is mainly in the field of fiscal policy that corrective action should be taken. During the period of mounting budgetary deficits the Central Bank, as financial adviser to the Government drew attention to the adverse consequences of these developments. As stated in the 1959 Report, for instance, the Bank during that year "repeatedly suggested the consideration of a number of remedial measures to reduce the budgetary gap, but for various reasons the Government either postponed or could not carry out the suggestions."

A further point needs emphasis. In conditions where the budgetary deficits reach magnitudes in excess of what could be financed from relatively non-inflationary sources, the Central Bank itself becomes an instrument of expansionist finance. The Central Bank, mindful of its statutory obligations, advised the Government of the dangers of continued inflationary finance. However, as agent of the Government in the management of the Public Debt it could not, as pointed out in the 1959 Report, "abandon its role of co-operation with the Treasury to meet expenses as had been budgeted." The discussion in the preceding section has already indicated the increasing extent to which there was recourse to the Central Bank for the financing of the budgetary deficits in recent years. The growth in importance of the Treasury Bill as an instrument of Government borrowing was itself an aspect of this development.

As shown earlier, so long as Ceylon's external reserves remained relatively large in volume these could serve to cushion the economy against the adverse effects of expansionist finance. However, during the course of 1959 the decline in reserves had proceeded sufficiently far as to suggest that corrective action could not prudently, be postponed much further. It was, therefore, particularly unfortunate that political events during the latter part of that year and in the first half of 1960 precluded effective action. In fact, as indicated in the Report for 1959, an attempt by the Central Bank to revise the Bank Rate from 2½ per cent to 3 per cent as part of a series of monetary measures proved abortive.

In December, 1959, Parliament was dissolved. The Parliament constituted after the General Election of March, 1960, was itself dissolved in April, 1960. A second General Election took place in July, 1960, and it was essentially with the formation of the Government after this date that corrective measures in the field of monetary and fiscal policy were possible. On August 12, 1960, the Minister of Finance introduced a series of measures aimed mainly at reducing the flow of imports into Ceylon. These measures were further supplemented by action taken by the Central Bank in the monetary field. Before outlining the measures themselves, however, it would be useful to discuss briefly some of the principal issues that are relevant to these measures as instruments of corrective action.

There were essentially two major considerations which determined the type of measures necessary. First, there was the need for effective action that would bring about a rapid reduction in imports and other outlays abroad and thereby stem the drain in external reserves. Second, there was the goal of reducing the inflationary pressures generated by the monetary expansion in general. In the context of a restricted flow of imports this latter consideration assumes added importance.

The measures that could be adopted towards these ends embrace those that could be taken by the Government as well as by the Central Bank. But, as mentioned earlier, it is in the field of Government policy that there exists the largest scope for corrective action. Monetary instruments could at best be used to supplement the wider policies adopted by the Government itself.

Governmental action directed towards the more immediate goal of a relatively quick reduction in imports can essentially be of three kinds. These are quantitative controls on imports, through licensing and similar devices ; higher import duties and exchange controls on outlays abroad in respect of such invisibles as foreign travel, remittances and so on. The less direct but more basic measure of a corrective nature is a reduction in the budgetary deficit itself. Action by the Central Bank in the monetary field, on the other hand, relates primarily to the restriction of commercial bank credit to the private sector—applied either selectively to imports, or to bank credit in general.

A consideration of some importance must be emphasised in this connection. Measures directed towards a reduction of imports, whether introduced by the Government or the Central Bank, have to take account of a common problem. This arises out of the preponderance of essential items or necessities of mass consumption in Ceylon's total import bill. It is natural that the main burden of the reduction in imports should fall on luxuries and relatively less essential goods. But in context of the pattern of Ceylon's imports, even drastic curbs on these categories—when these are narrowly defined—will go only a limited way towards reducing the total import bill. The increase in imports in recent years, in fact, covered a wide range of goods extending well beyond what may be described as luxuries or inessentials. Similar considerations apply to the magnitude of savings that would be possible through exchange control on invisibles since these, too, constitute—once transport and freight are excluded—a relatively minor proportion of Ceylon's total outlays abroad.

Within these limits, however, there exists a choice between the possible instruments that could be used to bring about a reduction in imports. In the field of Government action this choice relates either to the use of quantitative controls on imports, such as licensing through quotas and even total bans on selected items, or the introduction of higher import duties. In the case of quantitative controls the restriction is more or less immediate. With import duties, on the other hand, the reduction in imports is through a raising of prices to consumers.

There are certain merits and drawbacks inherent in each of these instruments. It should be emphasised that both devices tend to result in a raising of prices. With import duties, the rise in price follows, more or less directly, the introduction of the higher duty. In the case of quantitative controls, on the other hand, prices tend to rise in consequence of the curtailment of supply relative to demand. Quantitative controls, however, bring about a relatively quick and certain contraction in imports. The effect on imports of the raising of duties, on the other hand, is less certain. This would depend on the extent to which a raising of prices would affect consumer demand. It is difficult—particularly when money incomes are rising—to assess this response, and to determine accurately the degree to which duties should be raised so as to secure a given reduction in imports.

Despite these limitations, however, there is an important factor which makes the import duty a relatively superior instrument of regulation. The inflationary consequences of import regulation through duties are distinctly less than through quantitative controls. Although, as mentioned, both devices tend to raise prices in the first instance, the major part of the price increases effected through higher import duties accrues to Government in the form of revenue. These accruals represent, therefore, a siphoning away of purchasing power and contribute towards a reduction in the budgetary gap itself. In the case of quantitative controls, on the other hand, the increase in prices brought about by the reduction in supplies result in windfall profits to those importers who have secured licences and deal in the commodities in scarce supply. To the extent that these additional incomes constitute further purchasing power they augment, cumulatively, the inflationary and expansionist pressures in the economy. These considerations are of significance for policy. Where the need to reduce imports is urgent the use of the weapon of quantitative control is often inevitable. The inflationary consequences of this expedient may, however, be minimised through the simultaneous imposition of duties on the controlled items. In this way the magnitude of windfall profits to traders is reduced and a portion of the consumer outlay directed to Government revenue.

There are also some important considerations of relevance to monetary control by the Central Bank. As mentioned, the main instrument of action by the Central Bank is the control of the availability and cost of commercial bank credit to the private sector. Conventionally, the objective of monetary controls of this nature is to bring about equilibrium in the balance of payments by means of a general deflation in the economy and a reduction in total investment. Such a process is not, however, wholly appropriate for Ceylon. A general reduction of economic activity would react adversely not only on economic development but also on Ceylon's exports themselves. A curtailment in exports would in turn further aggravate the balance of payment problem, and thereby prove self-defeating. A more selective approach to credit control is therefore needed where emphasis is placed, as far as possible, on the direct reduction of credit for import—particularly for the import of less essential items. This implies that it is necessary to introduce new varients of monetary weapons fashioned in accordance with this objective. These considerations guided the choice of the measures actually adopted by the Central Bank during 1960 as outlined in the pages to follow. It is important to emphasise, however, that in a changing situation it is not desirable to place reliance on selective controls alone. In accordance with the changing liquidity position of the banking system, these measures would need to be reinforced with controls of a more general character which restrict the base for credit expansion itself.

The corrective measures introduced by the Government and the Central Bank during the course of 1960 reflect the several considerations discussed above. The measures adopted during that year fall into two stages :—those introduced in August 12, 1960, both by the Government and the Central Bank, and those announced by the Government on September 15, 1960, with the presentation of the budget for 1960–61. A further series of measures was introduced in January, 1961, but these fall outside the period covered by the present report.

The measures taken by Government in August, 1960, are as follows :—

Sharp increases were introduced in the rates of import duty on a variety of imported goods—particularly on motor vehicles, petroleum, certain categories of textiles, alcoholic beverages, tobacco and cigarettes, and watches. These were intended both to reduce imports and to augment the revenues of Government. Further, rigorous quantitative controls were introduced in respect of watches and textiles. The tax on locally produced tobacco used for the manufacture of cigarettes or pipe tobacco was also raised. Higher rates of export duty were imposed on cinnamon quills, coir fibre and papain. At the same time measures were announced in the field of exchange control restricting outlays on foreign travel and study abroad, and capital transfers.

Details of the monetary measures introduced by the Central Bank in August, 1960, are set out in Appendix I of this Report. Their chief features may, however, be summarised here :—

(*a*) The commercial banks were required with effect from August 13 :—

(i) to insist on 50 per cent cash margins against letters of credit for the importation of certain goods. The banks were also requested not to grant advances for the purpose of providing these margins. In order to make this requirement more effective importers were also required to import these goods only on letters of credit ;

(ii) not to increase the amount of their advances as at August 12, 1960, for the purpose of importing certain goods ;

(iii) not to finance hire-purchase operations in respect of certain goods except on the security of hire-purchase agreements resulting from the hire of such goods ; such advances should not exceed either 1/3 of the amount due by hirers to owners or $\frac{1}{4}$ of the value of goods hired, under such agreements, whichever is less; and

(iv) not to increase the amount of their advances for the purpose of purchase of certain goods.

(*b*) Also with effect from August 13, the Central Bank increased its rate of interest on advances to commercial banks, secured by the pledge of government securities, from $2\frac{1}{2}$ per cent to 4 per cent. However, a special concessionary rate of $2\frac{1}{2}$ per cent was allowed for advances against the pledge of usance promissory notes relating to the financing of the import of certain essentials, as well as of activities connected with domestic production and exports. At the same time the maximum rates of interest chargeable by banks on advances in respect of these transactions were fixed at the rates obtaining on August 12, subject to the condition that these rates were in no case to exceed 6 per cent.

(c) With effect from August 26, 1960, the commercial banks were required to increase their reserves with the Central Bank against demand deposits from 10 per cent to 12 per cent. The reserve requirement against Time and Savings deposits remained unchanged at 5 per cent.

In September, 1960, with the presentation of the Budget for 1960–61, a further attempt was made to reduce the budgetary deficit itself to proportions consistent with financing out of relatively non-inflationary sources.

The total estimates of expenditure and revenue in 1960–61 indicated a deficit of Rs. 470 million. Several new tax measures (described in Part II) were, however, introduced which sought to raise revenue by a further Rs. 130 million and to thereby reduce the deficit to Rs. 340 million. Rs. 100 million of the deficit was expected to be met out of an expanded flow of foreign aid, leaving a reduced residual deficit of Rs. 240 million to be financed out of domestic market borrowing. To the extent that these expectations are realised, the budget for 1960–61 would represent an important step in the field of corrective action.

A further development must be noted in this connection. During the course of 1960, and in the latter part of 1959, the rates of interest applicable to medium and long-term government borrowing were raised. Hence in November, 1959, the interest rate on a 16–20 year loan was raised to 3½ per cent as against the previous rate of 3¼ per cent for similar issues. Again, in November, 1960, a rate of interest of 4¼ per cent was offered on a 21–25 year loan. There was a similar upward trend in the Treasury Bill rate which increased from 2·08 per cent in January, 1960, to 2·6 per cent in September of the same year. The increase in the interest rates represents a raising of the return on the savings of the community.

It is naturally too early, at the present stage, to assess the impact which the several corrective measures discussed here would have exerted on the monetary and financial situation. As mentioned, these measures were later supplemented by further action. Towards the latter part of 1960, however, there was a fall in the monthly rate of imports. In fact, the total value of imports in 1960 was somewhat below the value of imports in the previous year. In addition, there was a decline in bank credit to the private sector towards the end of the year—despite an increase in bank liquidity over the same period. On the other hand, the Government's cash deficits during the last quarter of 1960 were substantially higher than during the last quarter of 1959.

Although there was an improvement relating to the rate of imports, following the measures of August 12th, it was considered necessary that they be reinforced by further corrective action. Accordingly steps of a more far reaching character were adopted by both the Government and the Central Bank in January, 1961. The measures introduced by the Government sought to effect a further reduction in imports ; whilst the measures of the Central Bank intensified the curbs on commercial bank credit to the private sector. These measures, however, as already mentioned, fall outside the period covered by this Report.