I. ECONOMIC PROBLEMS AND POLICIES—1962

Introduction

In 1962, according to provisional estimates, Ceylon's Gross National Product at current prices increased by 4.1 per cent. At constant prices, i.e. in real terms, the increase was 4.0 per cent. On the basis of an annual rate of increase in population of 2.7 per cent, the increase in real product per person was 1.3 per cent. The increase in total national product in real terms was largely due to an expansion in the production of goods for domestic use, specially paddy and fish. Although the relative contribution of industry to National Product remained small, there was also evidence of a heightening of activity in the field of industrial production. Production of export crops, which had risen in 1961 by 8.1 per cent, rose in 1962 by only 3.2 per cent.

The year 1962 saw no significant abatement of the expansionist factors at work in the monetary and financial field. The overall deficit in the government budget attained a magnitude similar to those of the years immediately preceding. In the financial year 1961-62 the government's cash operating deficit amounted to Rs. 457 million. Rs. 190 million of this sum was financed through credit creation by the banking system. The budget for 1962-63 as introduced in Parliament envisaged a reduction in the overall budget deficit and in the extent of expansionist financing. However, two proposals of relevance to this objective—a reduction in the amount of rice sold under the ration and the imposition of a sales tax on several categories of goods—were subsequently withdrawn. The budget for 1962-63, as finally approved by Parliament, entailed an overall deficit of Rs. 463·3 million and an uncovered gap of Rs. 133 million. Revised estimates of revenue and expenditure suggest, however, that these magnitudes might well be exceeded.

In earlier years the expansionist influence of the government budget resulted in a sustained demand for imports and a consequent decline in Ceylon's external reserves. The fall in export prices since 1960 further intensified the pressures on Ceylon's balance of payments. In 1961 imports were restricted by means of quantitative restrictions. In 1962 there was a further extension of these restrictions and their coverage was widened to include all but certain categories of essential goods. The imposition of direct restrictions on imports served to reduce the decline in external reserves. In 1961 and 1962 the fall in Ceylon's external reserves was Rs. 9·6 million and Rs. 27·8 million respectively. If Ceylon's purchases of Rs. 53.8 million in foreign currency from the International Monetary Fund in each of these years is excluded the use of external reserves would have amounted to Rs. 63·4 million in 1961 and Rs. 81·6 million in 1962. This compares with the losses in external reserves of Rs. 128·7 million, Rs. 199·2 million and Rs. 192·7 million in the years 1958, 1959 and 1960. It is possible, however, that the full impact of the import restrictions introduced in mid 1962 was not reflected in the payments position for that year.

With the intensification of direct controls on imports the impact of the monetary expansion would tend to fall primarily on the domestic level of prices. Unless the monetary expansion is itself curtailed or the reduction in the supply of imported goods is offset by increased domestic production a process of growing scarcities and rising prices would gather momentum. Such a process would tend to be pervasive in its effects and, if not contained within the strictest limits, result in pressures on wage levels and production costs throughout the economy. This could well jeopardize the competitive position of Ceylon's exports and impose hardships on those sections of the community whose incomes fail to keep pace with the rise in prices. In 1962 such factors as the continued deficit in external payments on current account, the availability of stocks of imported goods, the absence of restriction on imports of certain categories of foodstuffs and other essentials, and increases in domestic production served to restrain the upward course of prices. The Colombo Consumers Price Index—which is heavily weighted by subsidised or controlled items—increased only moderately by 1.4 per cent during the year. But indications of significant price increases in several categories of goods outside of the Index suggest the emergence of growing pressures on the general level of prices.

The situation arising out of import restrictions imposed for balance of payments purposes has, however, imparted a stimulus to the growth of domestic manufacturing industry. Although the contribution of industry to the Gross National Product remains small there was evidence of an extension of manufacturing activity in 1962 in both the public and the private sectors. Such a process, if pursued selectively and in terms of activities which hold promise of long-term viability, could mark the beginnings of a basic change in the structure of the Ceylon economy in the direction of greater industrialisation.

Part I of the Report presents a fuller analysis of developments in the Ceylon economy–particularly in the monetary and financial field–in the light of the several factors outlined above. A detailed factual and statistical account of the course of National Product and Expenditure, Foreign Trade, Prices and Wages, Money and Banking, Government Finance, the Balance of Payments, and Industrial Development in 1962 is provided in Part II.

(1) Economic Growth in 1962

As already indicated, according to provisional estimates, there was a rise of 4.1 per cent in Ceylon's Gross National Product in 1962 in terms of current prices. This was a considerable improvement relative to the increase of only 0.8 per cent attained in the previous year 1961. In terms of Gross National Product per person the increase in 1962 was 1.3 per cent as against a decline of 1.9 per cent in 1961.

In the absence of accurate data relating to price change it is difficult to derive a precise estimate of the course of Gross National Product in real terms. However, on the basis of available data, the rate of increase of real Gross National Product in 1962 is estimated at 4.0 per cent. The increase per person was 1.3 per cent. These rates were in excess of those experienced in 1961: 2.6 per cent in total real Gross National Product and —0.2 per cent in real product per person. They are indicative of the relatively better performance of the economy during 1962. The average annual rate of increase in real product per person over the two year period 1961 and 1962 was, however, only 0.6 per cent

The increase in total real National Product was largely due to an increase in the output of the domestic sector. There was an increase of 4.4 per cent in domestic sector output in 1962. Paddy and fish production in particular, are estimated to have increased substantially. There were also increases in industrial production and in construction by public enterprises. The output of the export sector increased by 3.2 per cent in 1962 as against an increase of 8.1 per cent in 1961. Actual exports in 1962, however, increased at a higher rate than production on account of a drawing down of stocks in the case of tea.

In 1962, as in the years immediately preceding, Ceylon's Gross National Product at current prices fell short of her Gross Domestic Expenditure i.e. total outlays on consumption and capital formation. This is reflected in the running down of external assets and the increase in external liabilities. However, in 1961 and 1962 the gap between Gross National Product on the one hand, and consumption and capital formation on the other, was substantially smaller than in 1959 and 1960.

Gross capital formation at current prices amounted to 13.6 per cent of Gross National Product in 1962. In 1961, on the other hand, gross capital formation constituted 14.1 per cent of Gross National Product. The decline in the relative share of gross capital formation in National Product in 1962 was largely due to a reduction in stocks. Gross capital formation on fixed assets increased, in fact, in 1962 by 9.0 per cent as against a decline of 6.5 per cent in 1961. The share of gross capital formation in fixed assets in Gross National Product increased from 13.9 per cent in 1961 to 14.8 per cent in 1962.

The increase in fixed capital formation took place in each of the two sectors of the National Accounts classification — i.e. Government and public enterprises, on the one hand, and private sector and public corporations on the other.[1] Fixed capital formation in the former sector increased by 10.8 per cent in 1962 and in the latter sector by 8.0 per cent.

(2) Government Finance and the Monetary Expansion

The Annual Reports of the Central Bank for recent years have pointed to the large overall deficits in the Government budget as the main source of monetary and financial disequilibrium in the economy leading, in the first instance, to a decline in external assets and, thereafter, with the introduction of import restrictions, to inflationary pressures on the domestic price level. The Annual Report for 1961 pointed further to the growing tendency for the initial estimates of the deficit in the Government budget to diverge markedly from the final outturn. Thus the budget for 1960-61, for instance, as initially approved by Parliament envisaged the reduction of the overall deficit to Rs. 340 million and the elimination altogether of the need for financing from expansionist sources. In the final result, however, the budget showed a cash operating deficit of Rs. 497.6 million and an extent of expansionist financing of Rs. 233.9 million. These variations were partly due to supplementary increases in expenditure, but they were in large part occasioned by shortfalls in revenues particularly in respect of expectations concerning the yield of new taxes.

The year 1962 surveyed in this report covers in part both the Government's financial year 1961-62 and the financial year 1962-63. Figures of final outturn are only available, however, for the year 1961-62. For the current year 1962-63, an indication of the budgetary pattern is provided by the estimates as approved by Parliament and by such revisions as have since been made. These data suggest that as in previous years the final result of Government finance is likely to show an

1 See Technical note on National Product and Expenditure, page 42.

overall deficit of a sizeable magnitude and a substantial extent of expansionist financing. Once again, there has been a notable divergence between initial expectations and final results.

The budgetary outcome for the financial year 1961-62 is described in some detail in a subsequent part of the present report. Only a broad summary of its major features need, therefore, be presented here. As originally approved by Parliament the budget for 1961-62 provided for a gross budget deficit of Rs. 329.4 million—to be met by domestic market borrowing, estimated at Rs. 200 million, and foreign aid, estimated at Rs. 140 million. No recourse to expansionist sources of finance was envisaged. In the final result the gross budget deficit amounted to Rs. 501.7 million and the net cash operating deficit—which adjusts for contributions to sinking funds and repayments of public debt—to Rs. 456.9 million. The extent of expansionist financing of this deficit reached Rs. 190.4 million. Total Government expenditures exceeded the initial estimates by Rs. 25.0 million, whilst the shortfalls in revenue and in foreign aid receipts were Rs. 151.4 million and Rs. 70.9 million respectively.

The Table below compares the net cash operating deficit and the methods of financing the deficit in 1960/61 with the years immediately preceding.

TABLE I-1

Financing of the Deficit 1958/59 to 1960/61

Rupees Million

	1958/59	1959/60	1960/61	1961/62 (Provisional)
1. Financing from non-bank sources (Total) of which:	**172·5**	**170·5**	**221·2**	**270·5**
(a) Administrative borrowing	27·6	57·4	29·4	104·5
(b) Domestic market borrowing from non-bank sources	111·9	86·5	165·2	107·8
(c) Foreign loans and grants	33·0	26·6	26·6	58·2
2. Domestic borrowing from banking system	**179·3**	**241·1**	**241·4**	**226·6**
3. Use of Government cash balances.. ..	**61·7**	**6·0**	**nil**	**-40·2**
4. Total net cash deficit	**413·4**	**417·5**	**462·5**	**456·9**
5. Adjustment for change in US counterpart fund account	**-52·5**	**4·0**	**-7·5**	**4·0**
6. Net expansionary impact of budget (2+3+5)	**188·5**	**251·1**	**233·9**	**190·4**

As shown in the Table above, the overall net cash operating deficit in 1961-62 was of a similar magnitude to the deficits attained in previous years. There was, however, a moderate reduction in the extent of financing from expansionist sources from Rs. 234 million in 1960-61 to Rs. 190 million in 1961-62. This reduction was due, however, to larger administrative borrowings rather than to increased domestic market borrowings from non-bank sources. The latter was, in fact, reduced in comparison with the previous year. Administrative borrowings totalled Rs. 104·5 million in 1961-62, an exceptionally high figure when compared to previous accruals from this source. The major sources of administrative borrowings were money order funds in transit (Rs. 17.9 million), and unexpended balances of the Ceylon Transport Board (Rs. 22.0 million) and of other Government agencies (Rs. 50.8 million). The availability of these funds helped to augment the Government's cash balances and to reduce the extent of financing from expansionist sources in 1961-62. Nevertheless, they are essentially in the nature of temporary deposits and working balances that are liable to fluctuate from time to time. Had they not been available the magnitude of expansionist financing from the banking system would necessarily have been greater.

As mentioned, net receipts from domestic market borrowings from non-bank sources declined in 1961-62. For the reasons outlined in Part II, however, this may be associated more with a shift on the part of non-bank investors towards the holdings of savings in more liquid form, than with a decline in the total volume of savings itself.

Accruals from foreign loans and grants as a source of finance for the overall deficit amounted to Rs. 58.2 million in 1961-62. Although substantially below the initial budgetary estimate (Rs. 140 million) these accruals reflect a stepping up of the utilisation of foreign aid resources in comparison with previous years. In the years 1959/60 and 1960/61, for instance, receipts from foreign loans and grants as sources of finance for the budget amounted to only Rs. 26.6 million in each year. To the extent that the receipt of financial resources from abroad are related to specific projects or programmes their utilization is dependant on the progress actually made on the execution of these schemes. Delays and shortfalls on this score have in the past been a major factor behind the divergence between estimated and actual receipts of foreign finance. In the financial year 1961/62 there was an increase in the total realised capital expenditure of Government. Capital outlays, inclusive of loans to Government agencies increased by Rs. 76.9 million from Rs. 519.1 million in 1960/61 to Rs. 596.0 million (provisional) in 1961/62. Capital outlays exclusive of loans to Government agencies, i.e. outlays on the acquisition, construction and maintenance of real assets increased by Rs. 41.1 million from Rs. 471.9 million in 1960/61 to Rs. 513.0 million (provisional) in 1961/62.

Whilst the expansionist impact of the budget for 1961/62 was a reflection of the divergence between actual budgetary outturns and initial expectations, the budget for 1962/63 as finally approved by Parliament, itself depicted an overall gross deficit of Rs. 463.3 million and an unfinanced gap of Rs. 133.3 million. Two proposals made in the Budget Speech which were aimed at a solution of the problem of excessive deficit financing were subsequently withdrawn. These were, first, the introduction of a sales tax on several categories of goods other than foodstuffs and, second, a reduction in the weekly ration of subsidised rice by one pound per person. The sales tax was estimated to yield Rs. 90 million whilst the estimated saving from the reduction in the rice ration was Rs. 25.5 million. In place of the sales tax a general increase of 20 per cent on existing rates of duty was imposed on a wide range of imports. The yield from this measure was estimated at Rs. 50 million.

The overall deficit of Rs. 463.3 million as shown in the budget as approved by Parliament was expected to be financed out of domestic market borrowings estimated at Rs. 180 million, and receipts from foreign aid, estimated at Rs. 150 million. The residual unbridged gap, as mentioned, was Rs. 133 million. Revised estimates of revenue and expenditure suggest, however, that both the overall budget deficit and the unbridged gap would be further widened. On the one hand, the total expenditure of Government is likely to increase on account of supplementary expenditures. On the other, there is likely to be a shortfall in revenue since import duty receipts would be affected by the restrictions on imports. At the same time, certain measures were introduced subsequent to the approval of the budget with the objective of offsetting these factors and of containing the unbridged gap to the level initially estimated. These included the withdrawal of rice ration coupons from paddy producers, the withdrawal of the subsidy on maldive fish, the imposition of a 1 per cent fee on import licences, the issue of paddy instead of rice in certain provinces, and the revision of the selling price of rationed rice, flour and sugar throughout the island to include transport charges from Colombo.[1] However, the first of these measures, the withdrawal of rice ration coupons from paddy producers, which was estimated to save Rs. 40 million, has since been suspended.[2] There is also the possibility once again of a shortfall in foreign aid accruals. Apart from the suspension of U.S. aid provided under the Foreign Assistance Act which would affect the budget for 1962/63 to the extent of Rs. 3.8 million, the actual utilisation of foreign aid resources may be affected as in previous years by under-spending on capital projects arising out of delays in execution and other factors. However, to the extent that such under-spending would affect the expenditure side of the budget as well, a shortfall in foreign aid receipts on this score would not itself contribute to a further widening of the budgetary gap.

In the absence of any additional measures that may be taken during the current financial year 1962/63 it is likely that recourse to sizeable borrowings from the banking system would again be needed as a means of financing the unbridged gap. Borrowings from the banking system as a source of finance for the budget exert a directly expansionary influence on the money supply. Such borrowings could take place through the medium of long and medium term Government securities, Treasury bills, and advances from the Central Bank. They comprise, therefore, contributions from both the commercial banks and the Central Bank. In terms of the Monetary Law Act, however, the Central Bank's advances to Government are limited to 10 per cent of the estimated Government revenue for each year. Moreover, the Act specifically precludes Central Bank subscriptions to new issues of long and medium term Government securities. The Central Bank's lending to Government, therefore, is through the medium of advances and of Treasury bills whilst commercial bank contributions could take place through the medium of long and medium term securities and of Treasury bills.

Government borrowings from the banking system—whether from the commercial banks or the Central Bank—for the financing of the budget deficit exert an expansionary impact on the money supply. However, commercial bank contributions to

1 Statement of the Hon. Minister of Finance in the House of Representatives on February 21, 1963.

2 Statement of the Hon. Minister of Commerce, Trade, Food and Shipping in the House of Representatives on March 8, 1963.

Government loans have not been of a sizeable magnitude in the past although such contributions have tended to increase in the more recent period following the rise in bank liquidity resulting from the reduction in Ceylon's external payments deficit. The major source of finance from the banking system has, therefore, been the Central Bank; and the Treasury bill has, in turn, been the chief instrument of Central Bank lending to Government.

The total value of Treasury bills outstanding is subject to a ceiling which can be raised only by Resolution of Parliament. In recent years, with the persistence of overall cash deficits in excess of what could be financed through borrowings from non-bank sources, there has been the need for successive increases in this ceiling itself. Thus during 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; in June 1961, during the financial year 1960/61, the authorised Limit was raised from Rs. 650 million to Rs. 750 million; in December 1961, in the course of the financial year 1961/62, the limit was increased further to Rs. 1000 million and, again in March 1963, during the current financial year 1962/63, the authorised limit was raised once more to Rs. 1150 million. Corresponding to these increases in authorised limits, there has been a steady expansion in the actual volume of Treasury bills outstanding. Thus the total volume of Treasury bills outstanding increased from Rs. 420 million at the end of 1959 to Rs. 625 million at the end of 1960, Rs. 775 million at the end of 1961, and Rs. 1000 million at the end of 1962. At the same time, the Central Banks' holdings of Treasury bills stood at Rs. 323.6 million at the end of 1959, Rs. 550.4 million at the end of 1960, Rs. 693.6 million at the end of 1961, and Rs. 872.4 million at the close of 1962.

The resort to Treasury bills as an instrument of borrowing from the banking system is the concomitant of the unbridged gap in the overall budget deficit. Given the shortfall between Government expenditure, on the one hand, and receipts from other sources, on the other, the Treasury bill issue, and the Central Bank's subscription to it, become the only available instrument for meeting the cash requirements of Government. If measures to reduce the gap between revenue and expenditure, or to augment borrowings or other receipts from non-bank sources, are absent or ineffective, there is no alternative but to have recourse to such expansionist means of finance. It is in this manner that a Government's obligations in respect of its payments and expenditures could in any case be met. The soundness or desireability of various magnitudes of expansionist financing through borrowings from the banking system —whether by means of the Treasury bill or other instruments—would depend on assessments of the monetary requirements for economic growth and on policy objectives relating to such factors as the relative stability of prices. An extent of expansionist finance that helps sustain monetary demand in the economy at levels beyond the availability of goods and services, whether domestically produced or imported, cannot but result in inflationary pressures on the level of prices. It is for this reason that the Central Bank has, in recent years, repeatedly drawn attention to the need, despite the difficulties involved, for reducing the excessive deficit in the Government budget so that continued recourse to the raising of Treasury Bills could be avoided.

Ceylon's experience in respect of some of the major budgetary proposals for 1962/63—the withdrawal of proposals for the introduction of a sales tax and for a reduction in the quantum of the rice ration, and the suspension of the scheme for the surrender of rice coupons from paddy producers—illustrates the difficulties in the way of attempts to reduce the overall budget deficit and hence the extent of expansionist financing. Yet, short of extended foreign aid or greatly increased borrowings from domestic non-bank sources—avenues which are themselves subject to limits—there is no path towards a reduction in the magnitude of expansionist financing save through an increase in revenue or a reduction in Government expenditure. The overall budgetary deficits of recent years have not, however, been caused by a contraction in Government revenue. On the contrary, Government revenue, though tending to fall short of the initial estimates, has shown a sustained increase in each of the years since 1958/59. Thus the annual increases in Government revenue were Rs. 73.4 million in 1959/60, Rs. 110.1 million in 1960/61, and Rs. 111.4 million in 1961/62. It is essentially the more rapid rise in Government expenditure that has prevented the curtailment of the overall deficit. Both the current and the capital expenditures of Government have increased in recent years. However, it was the current expenditure of Government that claimed the greater share of the increases in total outlays. Between 1958/59 and 1961/62 for instance, total Government expenditure increased by Rs. 338.4 million. Rs. 225.6 million or 66.7 per cent of this total increase was absorbed by current expenditures as against Rs. 112.8 million or 33.3 per cent by capital expenditures.

A scaling down of capital expenditure as a means of reducing the overall deficit would not prove a desirable expedient in the context of Ceylon. Although there may exist scope for improvement in the content of the capital programme, the objective of faster economic growth requires that the total volume of investment be augmented. This implies that the burden of reducing the overall deficit must fall on the side of revenues and of current expenditures.

As indicated above, Ceylon has succeeded in bringing about notable increases in revenues in recent years. She has made vigorous efforts on the tax front and has raised the level of taxation with successive budgets. The relatively high percentage which Government revenue bears to national income—rising from 20·5 per cent in 1951 to 25·7 per cent in 1962—is indicative of the degree of success achieved in the field of resource mobilization by Government. In the past, the percentage of Government revenue to national income tended to rise during periods of high export prices and to fall when export prices declined. This was a reflection of the close response of the tax structure to fluctuations in the export sector. In the more recent period, however, the percentage of revenue to national income has tended to remain high despite relatively unfavourable export prices. This is essentially the result of increases in the rates of taxation in respect of both direct and indirect taxes. In the field of direct taxation, apart from increases in rates, there has been, since 1958 the introduction of several new taxes. During the current year 1962/63 the tax system has been consolidated and the number of taxes reduced without significant effects on revenue. In the case of indirect taxes, there have been substantial increases in import duties. The percentage which total import duty collections bear to the c.i.f. value of all imports—the average rate of taxation of imports as a whole—increased from 30.5 per cent in 1953 to 44.5 per cent in 1962.

The Central Bank's Annual Report for 1961 pointed to the difficulties of securing continued increases in revenue from direct taxes on the basis of a relatively restricted tax base. As the possibilities in this field are exploited more fully not only do the additional accruals to revenue tend to narrow but incentives to effort and resources for investment outside of the public sector get reduced. Although tax incentive legislation could meet the latter problem in part at least, there would still remain the problem of securing additional resources for Government. This objective, however, could hardly be achieved outside of an extension of the tax base itself-whether through direct taxes or such indirect taxes as the sales tax and the import duty.

Given the limitations on the revenue side, a solution of the budgetary problem would involve reductions in current expenditure. The fact that total gross capital formation in Ceylon, through both the public and the private sectors, is only around 14 per cent of gross national income, despite the channelling of 26 per cent of national income to revenue, is a reflection of the heavy claims made by the requirements of current expenditures on the resources of Government. At the same time, there are formidable difficulties in the way of a reduction in current outlays. The requirements for administration, for development services, and for the provision of social services in the face of rapid population growth, impose heavy pressures towards a continued raising of the total volume of current outlays. There are in addition, the subsidies on food. These amounted to Rs. 235.4 million in 1961/62 and represented 14.8 per cent of the total of Government's current expenditures. The gross subsidy on rice alone, comprising both the producer and consumer subsidy and excluding the profits from sugar, amounted to Rs. 382.2 million. Paradoxically, at given rates of purchase and sale, the burden of the rice subsidy on the finances of Government would increase progressively as Ceylon's efforts to increase domestic rice production meet with success. The subsidy would also increase as rice consumption increases with the rise in population and incomes.

Reductions in the food subsidy, whether to consumers or producers, as a means of reducing the budget deficit affect the community in general or at least large sections of it. But it is also the case, unfortunately, that the continuance of an excessive budget deficit could also result in the imposition of hardships brought about by a more pervasive and sustained inflation in living costs and the level of prices in general. In fact, such a process if not effectively moderated could exert far reaching consequences, both social and economic, of an adverse character and render even more difficult the ultimate task of correction and stabilization. A curtailment of the extent of expansionist finance, despite the problems that confront this course, is, therefore, an essential need in the context of Ceylon today. A moderate degree of expansionist finance may prove consistent with the needs of an expanding economy. But an excessive monetary expansion, brought about through the medium of the Government budget, needs certainly to be eliminated.

(3) Repercussions of the Monetary Expansion

(a) *The External Balance*

As explained previously, one of the main consequencies of the Government budget has been the maintenance of a high level of monetary demand in the economy and a sustained pressure on the level of total imports. By 1960, however, the level of external reserves had fallen steeply and direct measures to reduce the quantum of imports became necessary. These measures took the form both of quantitative restrictions on imports through systems of quotas and licences, and of enhanced duties on imported goods.

Some quantitative restrictions on imports were imposed in August 1960 and their range was considerably extended in January 1961. However, the continuance of expansionist pressures in 1962 and the absence of a marked improvement in respect of export prices necessitated a further intensification of quantitative restrictions in that year as well. The range of items subject to individual import licensing was extended successively in February, July and September 1962. On October 10th 1962, however, it was decided to subject all items other than 5 categories of essentials to individual licensing procedures. The exempted categories were (i) Foodstuffs, (ii) Petroleum, (iii) Fuel, (iv) Fertilizers and (v) Drugs included in the Ceylon Hospitals' Formulary.

At the beginning of 1962 the range of items subjected to import licensing represented approximately 17 per cent of Ceylon's total imports in 1961 or Rs. 287 million in value. The restrictions of February, July and September, 1962 extended this range to cover goods whose imports in 1961 amounted to Rs. 505 million or 30 per cent of the total imports of that year. With the October restrictions this range was further extended to embrace items representing 48 per cent of 1961 imports or Rs. 811 million in value. These figures refer, of course, to the coverage of the licensing system. The degree of actual restriction of imports will depend on the size of the quotas that are permitted. According to official estimates, however, the restrictions of July, September and October, 1962 were expected to result in a saving of approximately Rs. 100 million in terms of 1961 imports once their full impact was felt.

In terms of customs data the actual reduction in imports in 1962, relative to 1961, amounted to only Rs. 43 million. In contrast, 1961 imports were Rs. 257 million below the level of 1960. The comparatively small reduction in the value of imports in 1962 may be due in part to the fact that the restrictions imposed during the year had not had time to exert their full effects and in part to the savings already effected in the previous year. An analysis of the customs returns does not suggest that there were substantial increases of an offsetting character in items not subject to restrictions.

Although the reduction in the total value of imports was relatively small in 1962 there was a considerable improvement in Ceylon's balance of trade. In the previous year 1961 Ceylon's balance of trade showed a small surplus of Rs. 30 million. In 1962, on the other hand, the trade balance had improved to Rs. 148 million. The fact that the trade balance improved by more than the reduction in imports is accounted for by an increase in export values during 1962. Export values rose from Rs. 1733 million in 1961 to Rs. 1808 million in 1962—an increase of Rs. 75 million. The increase in export values was wholly due to an expansion in the volume of exports. The quantity of tea exported increased by 6 per cent, the quantity of rubber by 13.7 per cent, and the quantity of coconut products by 12 per cent. These increases in export volumes were made possible, in part, by increases in production itself and, in part, by the running down of previously accumulated stocks. There was actually a moderate decline in the overall index of export prices which fell by about 2.1 per cent in 1962 relative to the previous year. The index of tea prices fell by 3.2 per cent and the index of rubber prices by 1.0 per cent. There was a small increase of 2.5 per cent in the average price of the three major coconut products. The decline in the overall index of export prices in 1962 was, however, less sharp that the fall in the preceding year. In 1961 the index of export prices declined by approximately 8.7 per cent. In 1962, on the other hand, on account of a decline in the overall import price index of 5·9 per cent, Ceylon's terms of trade improved moderately by 4·3 per cent.

The analysis above of the course of exports and imports in 1962 relates to trade data as depicted in the Customs Returns and concerns the physical inflow and outflow of goods. The impact of exports and imports on the country's balance of payments and on the level of external assets depends, on the other hand, on the flow of actual payments. For reasons outlined in previous Annual Reports there is no exact correspondence between the movement of goods and the flow of payments. Trade data recorded in the Customs Returns differ, therefore, from payments data as derived from the Exchange Control records and reflect differences in timing and classification. In 1962, however, the divergence between trade and payments data was particularly marked. Whilst the trade returns indicated a fall in the inflow of imports in 1962, payments data indicated a rise in payments for imports. This divergence, as explained in Part II page 100, may be due in part to the lagged arrival of foodstuffs paid for towards the close of 1962 and also possibly to delays in the recording of imports by Government of foodstuffs and other goods even after their arrival.

A review of the actual impact of exports and imports on Ceylon's external assets has naturally to be made in accordance with payments data. In terms of payments data Ceylon's merchandise account showed a deficit of Rs. 132.8 million in 1962 as against a deficit of Rs. 86.4 million in 1961 and a deficit of Rs. 209.9 million in 1960. The increase in the merchandise deficit in 1962 took place despite an increase in export receipts by Rs. 58.1 million and was due to an increase in import payments by Rs. 104.5 million. The increase in import payments was largely in respect of Government imports—both of foodstuffs and of capital goods. Both the quantity and the average price or rice purchased in 1962 was larger than in the previous years. There was actually a small decline in payments for private sector imports.

Whilst the deficit on merchandise account increased in 1962, Ceylon's balance on invisibles account was converted from a deficit of Rs. 7.4 million in 1961 to a surplus of Rs. 8.8 million in 1962. This was essentially due to higher receipts from foreign embassy expenses in Ceylon and to a reduction of the deficit on foreign travel and miscellaneous payments. The deficit on investment income was increased slightly on account of reduced interest earnings from Ceylon's external reserves. Ceylon's total balance on current account, comprising both merchandise and invisibles, showed a deficit of Rs. 124.0 million in 1962 as against deficits of Rs. 93.8 million in 1961, Rs. 220.5 million in 1960 and Rs. 208.0 million in 1959. On the capital side; a net inflow of Rs. 6.1 million on private capital account in 1961, contrasts with the net outflow of Rs. 6.0 million in 1962. The net outflow on direct investments—as against short term capital movements—was reduced from Rs. 7.8 million in 1961 to 0.7 million in 1962.

The impact of Ceylon's total deficit on current and private capital account on Ceylon's external assets and on Ceylon's external liabilities is summarised in the comparative table below:—

TABLE I–2

Balance of Payments for 1958–1962

Rupees Million

	1958	1959	1960	1961	1962 Provisional
1. Merchandise					
Exports	1624	1773	1796	1707	1765
Imports	—1713	—1958	—2006	—1794	—1898
Trade Balance	— 89	— 185	— 210	— 87	— 133
2. Services	— 41	— 11	— 32	— 18	— 2
3. Donations	— 23	— 12	+ 22	+ 11	+ 11
4. Current Account Balance ..	— 153	— 208	— 220	— 94	— 124
5. Private Capital	— 4	+ 2	— 5	+ 6	— 6
Method of Financing					
6. Official and Banking Capital (1)					
(i) Change in external assets ..	+ 129	+ 199	+ 193	+ 10	+ 28
(ii) Change in net external liabilities (2)	+ 44	+ 40	+ 3	+ 100	+ 88
(iii) Other (3)		— 36		— 2	
7. Errors and omissions	— 16	+ 1	+ 29	— 19	+ 14

(1) Plus sign represents decreases in assets or increases in liabilities.

(2) Net of repayment of loans shown in Table II H–3 "Total financing deficit".

(3) Figures reported against this item represent foreign currency contributions on account of the increase in Ceylon's quotas in the IMF, IBRD and IDA.

The Annual Report for 1961 pointed to a shift in the method of financing the external deficit that took place during that year—by means of an increase in external liabilities rather than a reduction in external reserves. As the table above indicates, the method of financing of the deficit in 1962 was broadly of a similar pattern. The fall in Ceylon's external reserves in 1962 was Rs. 27.8 million. This was somewhat higher than the fall in external reserves in 1961 of only Rs. 9.6 million. Ceylon's external liabilities on the other hand, increased by Rs. 81.9 million. A second drawing of foreign exchange from the International Monetary Fund of Rs. 53.8 million in February 1962 was the main item in the increase in liabilities. In the absence of this drawing or of further increases in other liabilities, the decline in Ceylon's external assets would have been Rs. 81.6 million in 1962.

The position in respect of Ceylon's external assets by the end of 1962 may be briefly outlined. Ceylon's external reserves at 31st December 1962 amounted to Rs. 503.9 million or 23.7 per cent of the payment for imported goods and services in that year. On the same date, the International Reserve of the Central Bank stood at Rs. 152.1 million representing 30.2 per cent of Ceylon's total external assets. At the end of 1961, on the other hand, the International Reserve was Rs. 184.7

million, Rs. 32.6 million in excess of the 1962 level. There was a moderate change in the liquidity pattern of the International Reserve. At the end of 1961 liquid assets, comprising cash balances abroad and holdings of Treasury bills and bills discounted, amounted to Rs. 92.2 million or 50.0 per cent of the total International Reserve. At the end of 1962, liquid assets stood at Rs. 86.0 million representing 56.5 per cent of the total International Reserve. There were considerable fluctuations in the level of the International Reserve during 1962. The International Reserve increased during the early months of the year, during the period of the commercial bank strike, declined during the middle of the year, and recovered once more during the closing months of 1962.

Ceylon's external liabilities stood at Rs. 473.9 million in 1962 as against Rs. 392.0 million in 1961. Although the recourse to increased external liabilities as a means of financing the external deficit affords a measure of protection to Ceylon's external reserves, the repayment of the liabilities when they fall due will constitute a corresponding burden on Ceylon's future balance of payments and external reserves. An examination of the maturity dates in respect of Ceylon's external borrowings indicates the emergence of such pressures from 1964.

The drawings of Rs. 107.6 million from the International Monetary Fund have to be repaid in full within a period of five years. This means that the repayment of the 1961 drawing would have to be completed by 1966 and the repayment of the 1962 drawing by 1967. In addition, two sterling loans amounting to Rs. 60·0 million and Rs. 24·6 million will fall due for repayment in 1964 and 1965. Sinking funds are available for the redemption of the two loans. However since sterling loan sinking funds are included in the published data on external assets, the redemption of the loans from the sinking funds will be reflected by a fall in Ceylon's external assets.

The continued decline in external reserves and the increase in external liabilities indicate that Ceylon had not stabilized its external balance within 1962, despite the intensification of import restrictions. Although the size of the payments deficit on current account was considerably below the magnitudes attained in the years immediately before 1961, it was somewhat in excess of the deficit experienced in the latter year. As mentioned earlier, however, it is possible that the full impact of the 1962 restrictions was not experienced within that year. In fact the evidence available for the first few months of 1963 indicates a reduction in import payments.

It would be possible, in principle, and within the limits of export earnings, to attain any given objective relating to the balance of payments on current account by means of the quantitative restriction of imports. Sufficiently drastic restrictions on imports could, for a period at least, serve to arrest or even reverse the trend of current account deficits. Such a result would not by itself signify, however, that the effects of the monetary expansion on the economy have been erased. On the contrary, the stemming of the drain in external reserves through the direct curtailment of imports could, given the continuance of the monetary expansion, only result in a shift in the impact of the pressure of demand away from the external account towards the domestic level of prices. This would lead to the generation of an inflationary process which could cause a cumulative rise in internal prices and costs. In the longer period it may not be possible to even maintain the immunity of the external account from the effects of this process. Rises in costs could adversely affect the output of the export sector itself and result in a decline in export earnings.

There are, moreover, practical limits to the extent to which imports could be restricted by quantitative controls. As the margin of luxuries and inessentials gets reduced the scope for further savings on imports becomes more narrow. In addition economic growth itself results in a rising demand for imported capital goods and raw materials. The introduction of quantitative restrictions on imports tends itself to stimulate the production of domestic substitutes and to increase the need for imported materials and equipment. There is also the further possibility that the scarcities and the rise in prices brought about by import restrictions would themselves result in pressures towards the relaxation of these restrictions—particularly in the case of semi essential goods which enter into mass consumption. These pressures may prove difficult to withstand, particularly in the context of a general increase in living costs. All these factors suggest that even if it were possible to introduce a severe degree of import restrictions in an initial phase, it may be difficult to sustain these restrictions over a prolonged period. Except to the extent that imports would be saved through the domestic production of import substitutes reductions in imports through quantitative restrictions would not, for all these reasons, represent a permanent strengthening of the country's external payments position.

(b) *The Domestic Price Level*

As previously explained, the continuance of the monetary expansion through the medium of the budget, together with the quantitative restrictions on imports, would result in the imposition of inflationary pressures on the domestic price level. However, it is not possible, in the absence of a satisfactory index of changes in the general level of prices, to measure the actual impact of these pressures on prices in Ceylon during the course of 1962. The Colombo Consumers' Price Index seeks to measure changes in the prices of items entering into the pattern of working class consumption in Colombo. Its coverage is, for this reason, limited; and items whose prices are subsidised or controlled, or which are not subject to significant import restrictions, enjoy a relatively heavy weightage in the index.

The increase in the Colombo Consumers' Price Index in 1962 was of a moderate order. The index as a whole increased from an average level of 104.8 points in 1961 to 106.3 points in 1962 (base 1952 = 100). This represents an increase of 1.4 per cent over the year. The domestically produced items which enter into the index increased by 1.4 per cent in price and the imported items by 2.2 per cent. Export items actually declined by 4.5 per cent but their weightage in the total is small. Moderate increases in prices were registered by the index in respect of different categories of commodities. Thus food items increased by 1.1 per cent, clothing by 4.1 per cent, fuel and light by 1.1 per cent and miscellaneous items by 1.7 per cent. There has been no change in the index of the rent group since 1954.

It is likely that for the reasons mentioned above, the Consumers' Price Index understates the general increase in the price level in the present situation. Apart from the quantitative restrictions on imports and the monetary expansion brought about by the budget deficit, there have been significant increases in import duties over a relatively wide range of goods. It has been a conscious objective of policy to avoid the imposition of quantitative restrictions as well as of customs duties on essential imports as far as possible. It is likely for this reason that price increases would have been greater in the range of goods which fall outside of this category. At the same time, it would be difficult to wholly insulate particular categories of goods, particularly if they involve a large number of items, from the pressures arising out of an inflationary situation. Even if it were possible to increase total supplies in these categories, increases in cost items, covering for example, transport and distribution, tend to be transmitted to the level of retail prices. Such increases in wage rates as may occur in periods of rising prices also exert similar effects. All this is a reflection of the pervasive character of an inflationary process.

It is possible, whatever the actual increases in prices that took place in 1962, that the full impact of the monetary expansion was not experienced in that year. In the first place, the fact that the balance of payments on current account continued to be in deficit to the extent of Rs. 124 million suggests that Ceylon was able to have recourse to a volume of imports in excess of her earnings from abroad. Had it not been possible for Ceylon to run down her external reserves and to increase her external liabilities a greater degree of restrictions on imports would have been necessary and the pressure on the price level would correspondingly have been sharper. In the second place, stocks of imports built up prior to the imposition of quantitative restrictions continued to be available to some extent to meet the pressure of demand. Third, the monetary expansion would have been offset to some extent by the increase in domestic production. Both agricultural and industrial output in Ceylon increased in 1962. To some extent there was a substitution of imports by domestic production and this would have served partially at least to offset the reduction in imported supplies in respect of certain items. Finally, there was a moderate decline in the c.i.f. prices of imports. The overall import price index declined by 5.9 per cent in 1962, relative to the previous year. The price index of imported investment goods registered a decline of as much as 17.9 per cent, whilst the indices for intermediate goods and consumer goods declined by 4.5 per cent and 2.0 per cent respectively.

Several of these factors cannot however be expected to afford a continuing source of relief to the price level in the future. Unless export prices were to rise Ceylon would require a considerably greater degree of restriction on imports than took place in 1962 if a decline in external assets or a further increase in external liabilities is to be avoided. As mentioned earlier, import restrictions were, in fact, intensified during the latter part of 1962 although their full impact was not felt during that year. Similarly, the position in respect of previously imported stocks cannot remain unchanged. As stocks are drawn down scarcities will become more acute and prices would tend to rise further. Moreover, such stocks as continue to exist will tend to be hoarded in anticipation of increases in prices and this would itself aggravate the upward price trend. Falling external prices of imports apart, there would then remain the prospect of increased local production as an offsetting factor in the domestic inflation. Increased domestic production could undoubtedly exert a beneficial effect on the price level in general. But at the same time it would clearly be unrealistic to expect that a substantial monetary expansion could be absorbed in this way. As shown earlier, the large overall deficits in the Government budget have been associated with an increase in total expenditure, the greater part of which was diverted to current rather than to capital purposes. But even a process of capital formation financed by an excessive expansion in the money supply could result in inflationary pressures on prices since the interval between the making of investments and their maturing is often protracted. In addition such investments would result in claims on foreign exchange resources that would otherwise have been available for the import of consumer goods. These pressures themselves serve to raise the costs of domestic production and result in a raising of the prices of the newly produced goods.

In the absence of an effective reduction in the extent of the monetary expansion, therefore, Ceylon faces the prospect of an inflationary process in the domestic economy. Such a process, unless restrained in time, would tend to gather momentum as initial increases in prices are followed by increases in wages and costs. The impact of an inflation falls unequally on different sections of the community. Those whose money incomes do not keep pace with the rise in prices bear the greatest burdens. At the same time inflation places a premium on speculative activities and tends to swell the profits from this source. Moreover, in the context of an export economy, an inflationary process could react unfavourably on the rate of growth of the economy itself. Whilst producers for the domestic market may succeed in passing on increases in wages and costs to domestic consumers, producers in the export sector are clearly unable to follow this course. A rise in the production costs of exports could only result in a weakening of the competitive position of the export sector and in a decline in export earnings as the output of marginal producers gets affected. This will influence adversely not only the balance of payments but the surplus for investment as well and thereby reinforce the monetary disequilibrium in the economy.

A rise in prices is not the only aspect of a monetary expansion accompanied by severe quantitative restrictions on imports. Such restrictions could also result in rigidities and delays which impede the smooth flow of economic activity. To be effective in reducing outlays on imports, a scheme of restrictions has necessarily to be relatively comprehensive. This implies that a wide range of goods, beyond the category of consumer luxuries, has to be brought within its ambit. At the same time it is difficult however efficient the administrative process, to foresee and assess accurately the whole complex of requirements for the unimpeded maintenance of economic activity. At least delays would be involved which slow down the pace of work. To some extent these difficulties could be met by the adoption of relatively flexible instruments of control. As pointed out in the Annual Report for 1961, for instance, the use of the import duty rather than import licensing as an instrument of import restriction could result in the maintenance of a greater degree of flexibility in respect of the flow of imports. Although higher import duties themselves result in a raising of prices they tend on balance to be disinflationary in effect. Import quotas even if unaccompanied by duty increases result in a raising of prices through the restriction of supplies relative to demand. But whilst in the case of import duties a portion of the increase in price accrues to Government and serves to reduce the overall deficit, with quotas the benefit of price increase accrue to traders through higher profits and thereby enhances further the expansion in money incomes. Price increases that serve to reduce the budget deficit could in fact constitute an instrument in the control of inflation. In recent times increasing use has, in fact, been made of the import duty as an instrument of import restriction. But in the context of a continuing need for direct action to restrain imports there is possibly further scope for the selective use of this instrument.

(c) *Money Supply and Commercial Bank Credit*

The imposition of direct restrictions on imports in the context of an expansionist budget tends also to result in a changed situation in the field of money supply and commercial bank lending. Prior to the adoption of direct restrictions the expansionist impact of the budget led, as mentioned before, to increased outlays on imports and an adverse balance of payments position. This exerted a restraining effect on both the increase in the domestic money supply and the rise in the liquidity position of the commerical banks. With attempts to correct the payments deficit through direct restrictions on imports the offsetting influence of this factor on money supply and bank liquidity would tend to be reduced. The resulting tendency for money supply and bank liquidity to increase could further reinforce the expansionary pressures in the economy. The extent to which all these factors were in operation in 1962 is analysed in broad outline in the discussion that follows.

Ceylon's total money supply—comprising both currency and demand deposits held by the public—increased by 54 million from Rs. 1,289 million at the end of 1961 to Rs. 1,343 million at the end of 1962. The change in the money supply and the factors responsible for it are analysed in the table below:

TABLE I — 3

Change in Money Supply (End of Period 1961–62)

Rupees Million

Expansionist Factors	
(a) Government borrowing from the banking system	231·6
(b) Commercial bank credit to the private sector	42·2
Total	**273·8**
Contractive Factors	
(a) Change in external banking assets	91·1
(b) Increase in time and savings deposits	50·9
(c) Government cash balances	76·1
(d) Adjustments	1·7
Total	**219·8**
Net change in money supply	+ **54·0**

As shown above, Government borrowing from the banking system for the financing of the budget deficit was the main causal factor in the increase in the money supply during 1962. The extent of the increase in the money supply, however, fell short of the extent of credit expansion by the banking system. This was due to the fact that external banking assets continued to decline on account of the persistence of the external payments deficit, and also to a rise in time and savings deposits and in Government cash balances. In the absence of these offsetting factors the increase in the money supply in 1962 would certainly have been larger.

The increase in the money supply took the form of both an increase in currency held by the public and an increase in demand deposits. The currency component of the money supply increased from Rs. 692.2 million at the end of 1961 to Rs. 712.6 million at the end of 1962. Over the same period demand deposits held by the public increased from Rs. 596.4 million to Rs. 630.0 million. There was a slight decline in the percentage which the currency component bears to total money supply–from 53.8 per cent at the end of 1961 to 53.1 per cent at the end of 1962. Nevertheless the share of currency in the total, relative to bank deposits, remains high. Once again there was a faster rate of increase in the issue of currency notes of the higher denominations of Rs. 100 and Rs. 50. This is an indication of the continued use of currency for larger transactions and for the holding of assets in liquid form.

Commercial bank credit, whether to government or to the private sector, had not in the past played a significant role in the monetary expansion. However, the improvement in liquidity that tends to take place in the new situation could result in a strengthening of the base for credit expansion on the part of the commercial banks and in this way aggravate the inflationary forces at work in the economy. A policy of restraint on bank credit, pursued selectively, becomes in these circumstances a necessary part of overall monetary policy.

The total liquid assets of the commercial banks—comprising cash on hand and deposits at the Central Bank, Foreign balances, Treasury bills and bills discounted —which had declined sharply in 1957 and 1958 have increased once again in the period thereafter. On the basis of average monthly figures the total of liquid assets which had fallen to Rs. 301 million in 1958 increased progressively to Rs. 466 million in 1962. The increase during the latter year alone amounted to Rs. 91 million. These developments influenced the course of commercial bank lending to both the private and the government sectors.

The course of commercial bank lending to the private sector is summarised in the table below.

TABLE I — 4

Commercial Bank lending to the Private Sector

(Average of Monthly Figures)

Rupees Million

	1960	Increase over previous year	1961	Increase over previous year	1962	Increase over previous year
Bills discounted	115	— 4	122	+ 7	136	+ 14
Loans and overdrafts	430	+ 35	435	+ 5	478	+ 43
Total domestic lending to the Private Sector	545	+ 31	557	+ 12	614	+ 57

There was, as shown above, an increase of commercial bank lending to the private sector of Rs. 57 million, on the basis of average monthly figures, in 1962. This increase, though larger than the corresponding increase in 1961 was nevertheless of a secondary order relative to the magnitude of monetary expansion generated by the budget deficit.

One of the developments in 1962 was the increase in commercial bank subscriptions to Government loans. In the years immediately prior to 1961 the commercial banks were not significant contributors to Government loans. In 1961, however, commercial bank subscriptions to Government loans increased by Rs. 27 million—mostly on account of subscriptions to Treasury bills. In 1962 this increase was stepped up further. Commercial bank investments in Treasury bills and Government and Government guaranteed securities rose by Rs. 51 million in that year. Once again, purchases of Treasury bills were the chief means of commercial bank lending to Government The banks' holdings of Treasury bills increased by Rs. 38 million in 1962. As mentioned, these developments reflect, in large part, the improving liquidity position of the commercial banks in the present context.

The situation in respect of the country's balance of payments and of the changed liquidity position of the banks necessitated several monetary measures aimed at the selective control of both the volume and direction of commercial bank credit. A series of such measures were introduced by the Central Bank since 1960. Some of these were directed towards a reduction in the volume of credit for imports; others aimed at restraining the overall expansion in credit that could otherwise take place, particularly in respect of fields of lesser priority in the present situation. Thus in August 1960, cash margin requirements were imposed against letters of credit for selected imports and restrictions were placed on the financing of hire purchase operations. The Central Bank's rate of interest on advances was also increased at the same time from 2½ per cent to 4 per cent. In February 1961 an effective reserve ratio of 50 per cent was established for all demand deposits above an established margin. Again, in October 1961, loan and overdraft facilities granted to foreign firms other than in the export trade were required by Exchange Control to be curtailed by one third. In December 1962 the Central Bank directed that commercial bank credit for the purchase of estates, whether foreign owned or not, should not exceed 33 1/3 per cent of the purchase price of such estates. This restriction is also applicable to credit for the purchase of immovable properties other than estates belonging to non-residents or companies operating outside Ceylon.

These measures influenced the direction and cost of bank credit to the private sector as well as its overall magnitude. For instance, the Annual Report for 1961 pointed to the increasing trend in respect of interest rates that was in evidence in that year. There was a tendency for interest rates to increase slightly in 1962 as well. The direction of commercial bank credit to the private sector changed only slightly. However, although there was an increase in the total of commercial bank credit, the Central Bank's survey of advances indicates that between September 1961 and June 1962 advances for financial purposes such as hire purchase activities, and for commercial purposes, particularly import payments, actually declined. In contrast there was a slight increase in advances for agricultural and industrial purposes. However, advances for consumption and for other purposes also increased, As mentioned in previous reports, the scope for monetary policy alone to offset the inflationary consequences of the overall budget deficits is severely restricted. At best, by restraining a secondary expansion in bank credit and by directing the flow of bank credit towards production and other essential purposes, monetary policy could serve as a supplement to such remedial measures as are taken by the Government itself. But as long as the expansionist impact of Government finance is allowed to continue the effectiveness of these measures would necessarily be limited. The basic solution to Ceylon's financial problem has, therefore, to be found in the field of Government finance.

(4) Conclusion

The discussion in the preceding sections has outlined the serveral forces at work in the monetary and financial field. It has indicated that the basic factor underlying the monetary disequilibrium—the recourse to expansionist sources for the financing of the budget deficit—has remained substantially uncorrected during 1962. The possible consequences of this situation in terms of the country's external balance and the domestic level of prices have also been analysed. It has been pointed out that with the introduction of quantitative restrictions on imports the Ceylon economy faces a changed situation in which the pressures of the monetary expansion tend to shift away from the external account towards the internal price level. The possible dangers inherent in this process, if allowed to continue unrestrained, have been emphasised and explained. As an inflationary process gains in intensity the task of correcting it becomes increasingly difficult. It has been the experience of several countries that a severe inflation had often to be followed by a stabilization programme of a far reaching and painful character. The inflationary process in Ceylon has not so far reached the magnitudes that have at times been attained in other regions. But an initiation of the process has clearly taken place and there is the need for adequate and timely measures to hold it in check.

The urgent need in Ceylon is for a stepping up of the pace of development. It is a fact that despite the channelling of substantial financial resources to Government through taxation, and the supplementing of these resources through expansionist means, the total volume of capital formation in the country remains inadequate in the light of the requirements for rapid growth. Although Ceylon's national product has been growing in real terms the rate of expansion has exceeded population growth by only a narrow margin. In addition, it is unlikely that employment opportunities have kept pace with the rise in the workforce. There have, however, been encouraging increases in certain sectors of the economy. The output of tea, for instance, has maintained an upward trend for many years. There has also been an increase in the domestic production of paddy and of other crops. It is of the utmost importance that these gains should continue in the future. From the point of view of the long-term structure of the economy there has, however, been a further development which is of undoubted significance. This concerns the increase in industrial activity in the recent period.

Recent developments in the field of industrial production in Ceylon are described in a succeeding section of this Report. Although there is a lack of precise data it is evident that there has been a rise in the tempo of domestic manufacturing activity. The contribution of domestic industry to National Product remains small and in many cases ventures are still in the process of being established. Nevertheless several beginnings have been made which could be of importance to a process of industrial development. The quantitative restrictions on imports imposed for balance of payments reasons have themselves given an undoubted stimulus to domestic manufacture. This has been one of the favourable by-products of these restrictions in so far as they have been applied to fields where there is prospect for domestic manufacture. But it is of importance, at the same time, that the basis of future industrial growth be soundly established. The considerations that determine the incidence of import restrictions for balance of payments purposes are not necessarily those that should guide the establishment of domestic industry. Import restrictions afford a measure of protection to local industry. Nevertheless, the burden of such restrictions tends to fall more heavily on the less essential consumer goods. Whilst there may be scope for domestic production in these fields as well, Ceylon's future industrial structure should not be the outcome of these factors alone. The question of the structure of industry appropriate for Ceylon needs, therefore, to be kept in the forefront of industrial planning and policy. It is important that from the outset considerations relating to the long-term viability of industries should find reflection in the pattern of industrial development in Ceylon.