1. ECONOMIC PERFORMANCE, PROBLEMS AND POLICIES – 1968

Introduction

The main feature of economic growth in 1968 was a high rate of expansion in the volume of goods produced and consumed at home in the agricultural and industrial sectors. This increase in output was strengthened by an appreciable improvement in export earnings.

It was mentioned in the Annual Report for 1967 that, despite the persistence of unfavourable world market conditions, the Ceylon economy was able to realize a substantial growth rate which was firmly rooted in production for domestic use. The forces that brought about economic recovery in 1967 gathered momentum and the economy grew at an accelerated pace in 1968. The sources of growth are summarised in the table shown below.

TABLE I - 1

Main Components of Economic Growth (at Constant Prices)

Rs. Million.

Items	1966	1967	1968
Increase in Gross National Product at Constant Prices over previous year	+ 283	+ 347	+ 680
of which:			
1. Total agriculture ..	+ 64	+ 203	+ 209
(a) Exports	— 37	+ 16	+ 56
(b) Other agriculture	+ 101	+ 187	+ 153
2. Manufacturing	+ 71	+ 44	+ 81
3. Transport, storage & communications ..	+ 52	— 10	+ 42
4. Construction	+ 27	+ 58	+ 95
5. Others	+ 69	+ 52	+ 253

Evidently non-export agriculture made a significant contribution to the increase in Gross National Product from 1966. In that year, paddy production recovered substantially from the low levels of the previous year; since then, the growth in this sector has been sustained and has in fact more than offset the decline in external economic circumstances due to such factors as increase in prices of imported goods such as rice and an adverse movement in the terms of trade.

The rate of increase in Gross National Product at constant prices (i.e. in real terms) was 8.3 per cent in 1968 compared with an increase of 4.4 per cent in the previous year. When allowance is made for population growth of 2.2 per cent in that year, the rise in per capita real product of 6.1 per cent is the highest growth rate achieved so far. But for the decline in the terms of trade of 7.9 per cent, real income would have risen at a corresponding rate.

The balance of payments in rupee terms was more unfavourable in 1968 than in 1967. The high rate of growth in real national product was accompanied by a larger import surplus than in the previous year. In dollar terms, however, the import surplus was less in 1968 than in the previous year. Following a slight decrease of 1.1 per cent in 1967, there was an 18 percent increase in imports in 1968 due partly to a rise in rupee costs (due to devaluation) and partly to the liberalisation of imports after the exchange reforms introduced in May 1968. Though export earnings rose by Rs 345 million (20%) as compared with a decline in the previous year, it was not adequate to arrest the adverse trend in the balance of payments position. The acceleration in export earnings reflects almost entirely a price increase and to a very small extent a volume increase.

By 1967 it was becoming apparent that the stringent controls were not capable of solving the main balance of payments problems. The introduction of the Foreign Exchange Entitlement Certificate Scheme (FEECS) in May 1968, closely following the devaluation of November 1967, was a major step towards solving this problem. It was designed to bring the rupee costs of a wide range of imports more closely to the realistic value of foreign exchange while at the same time liberalising imports, especially essential inputs of industry in order to give a greater dynamism to the growing sectors of the economy. The details of the scheme are discussed elsewhere.

In the context of a strained payments situation, Ceylon will have to rely heavily on increased and continued flow of foreign aid. In fact the large deficit in 1968 was financed mostly through commodity and project aid and short-term borrowings including drawings from the International Monetary Fund. For this reason the recourse to the use of external reserves was minimised. Though the balance of payments in 1968 showed a larger deficit than in 1967, the decrease in net external banking assets was smaller.

Value of imports in 1968 was higher in relation, to total output. There was a backlog of demand accumulated over the past years. With the liberalisation of trade and payments there would have been a natural tendency for imports to rise. In fact, value of imports rose by 25 per cent; nearly half of this increase was in consumer goods, the increase in intermediate goods accounted for nearly 34 per cent.

Net external banking assets declined by Rs. 116 million but the monetary effect of this was more than offset by an expansion of credit to Government by Rs. 192 million and to private sector by Rs. 264 million. The rise in credit to the private sector reached a peak level during this year. The (end of year) level of money supply moved up by 6 per cent and was less than the expansion in the previous year.

Despite a slower rate of expansion in money supply and a higher rate of growth of real product, prices moved up faster than in 1967. It would be recalled that in past years monetary expansion was well above the expansion in real output. Under stringent import and exchange controls this monetary expansion did not fully leak out of the economy through balance of payments deficits. Nor were there adequate supplies of domestically produced goods to mop up the resulting excess liquidity in the economy. Prices were also prevented from moving up as fast as they would normally have under these circumtances in view of price controls and rationing. Consequently, by the end of 1967 there was substantial pent up demand in the economy built up over several past years In fact the liquid assets in the hands of the public amounted to as much as 48 per cent of GNP in 1967. This liquidity ratio dropped to 44 per cent in 1968 while the income velocity of money went up from 4·7 to 5·3. Thus while monetary expansion in 1968 itself was lower than in 1967 and the expansion of real product substantially higher, the pent up demand of previous years combined with a higher velocity of circulation resulted in the price level going up faster.

Government revenue increased by 10·3 per cent, but total Government expenditure showed even a sharper increase by 12·1 per cent over the previous year. On the revenue side the main increases were in export tax receipts, excise duties and profits from the sale of FEECs. Of the increase in expenditure nearly 71 per cent was accounted for by current expenditure while capital expenditure accounted for the balance.

Savings deposits in commercial banks increased by Rs. 125 million while other forms of institutional savings rose by Rs. 30 million of which deposits in Post Office Savings Bank increased by Rs. 12.4 million. This increase in savings was nearly 10 per cent of the increase in Gross National Product. This savings figure excludes other types of personal savings which too would have risen during the year consequent to a rise in incomes.

Gross Domestic Expenditure had been in excess of available resources during the last decade (except for a small surplus in 1965) and the excess expenditure had to be met by drawing down external savings (assets) and from receipts of international gifts and transfers.

In 1968 too Ceylon lived beyond her means. Aggregate expenditure on consumption and investment exceeded the value of goods and services produced by 3·6 per cent. Accordingly the deficit had to be met largely by increased indebtedness abroad and foreign assistance.

A. Economic Performance

(a) National Product

The rate of growth of real national product accelerated in 1968, and was nearly twice the rate achieved in the previous year. According to provisional estimates made by the Central Bank, Gross National Product at constant prices (in real terms) rose by 8·3 per cent over the previous year compared with a rise of 4·4 per cent (revised estimate) in 1967. Gross National Product at current factor cost prices increased sharply from Rs. 8,224 million in 1967 to Rs. 9,809 million in 1968 or by 19·3 per cent. Thus, an average price rise of nearly 11 per cent has been observed on the basis of an implicit price index.[1] The price increases were particularly pronounced in the export and import sectors as was to be expected after devaluation. Manufacturing and construction showed price increases of 20 per cent and 7 per cent, respectively—reflecting the higher rupee prices of imported goods due to the devaluation and the Foreign Exchange Entitlement Certificate Scheme.

Real national income (i.e. Gross National Product at factor cost prices adjusted for the movement of terms of trade) rose by 7·0 per cent thus indicating a fall of 1·3 percentage points in Gross National Product as a result of a decline in the terms of trade. The adverse terms of trade led to a reduction in real product by Rs. 821 million.

The mid-year population is estimated to have been 11·96 million giving a growth rate of 2·2 per cent which is slightly lower than the rate in 1967, Thus, in per capita real terms the increase in Gross National Product amounts to 6·1 per cent over the previous year. This very satisfactory performance of the economy was mainly due to a rapid growth in agriculture, manufacturing and construction. In fact, the growth rate in real terms in construction reached one of the highest levels in recent years; it was 27 per cent. more than in the previous year. In contrast to the previous year when per capita income in real terms rose by 2 per cent the rate of 6·1 per cent in 1968 was a remarkable achievement.

Of the increase of Gross National Product, nearly 13 per cent was allocated to investment; consumption absorbed 87 per cent of the rise.

Total private consumption was 13 per cent more than in the previous year and was only slightly less than the growth rate in Gross National Product. The rise in private consumption at this rapid rate is a matter for concern especially when some of this increased consumption could cause an increase in imports thereby creating an import surplus and problems of balance of payments deficits.

Investment had risen by 21 per cent above the previous year in money terms. There is a large price element in this computation as import prices of some commodities rose as much as 30 per cent. The demand for investment was largely due to the increasing need in the private manufacturing and construction sectors and the other was due to expansion in the provision of social and economic overheads.

Gross capital formation by type of capital goods in the private sector and public corporations indicate that building construction which comprised 45 per cent of the total, increased from Rs. 520 million in 1967 to Rs. 702 million in 1968 or by 35 per cent. Clearly this satisfactory performance was due to the larger availability of imported building materials, higher local production of cement, rolled steel

1. An implicit price index indicates the extent to which the average level of prices would have moved had there been a general index of the price level. The implicit price index is obtained by dividing the GNP at current prices by the GNP at constant prices.

and wire and other materials and due to the general improvement in economic activity. Public corporations more than doubled their investments in machinery and equipment from Rs. 34·5 million in 1967 to Rs. 69·6 millon in 1968.

The Gross Domestic Expenditure at market prices was higher than Gross National Product by 3·6 per cent. This deficit was financed through increase in international indebtedness and net receipts of international gifts and transfers

(b) Fiscal and Monetary Developments in 1968

1. The Government Budget 1967/68

Revenue collections of the Government according to provisional data amounted to Rs. 2,156.4 million in 1967/68 and was Rs. 201.6 million (or 10.3 per cent) more than the collections in the previous financial year.

The average rate of growth of revenue over the past ten years was 5.4 per cent per annum: increase in 1966/67 was 6.2 per cent. The satisfactory performance in the revenue collections in 1967/68 was largely due to measures designed to collect revenue at the expenditure stage in the form of indirect taxes and from profits on the sale of FEECs.

About Rs. 77 million had been collected from the Foreign Exchange Entitlement Certificate Scheme from May to September 1968. The increase in revenue from export duties reflected an increase in export taxes on tea and rubber; price increases which occurred after devaluation and a small expansion in exports. A fall in revenue from import duties by Rs. 30 million reduced its importance in the revenue structure from 27.8 per cent in 1966/67to 23.8 per cent in 1967/68. Reduction in import duties on some items, the abolition of import licence fees for most of the imports and a fall in the value of dutiable imports accounted for this decline. Measures designed to increase revenue through excise duties brought in a further Rs. 39 million, the bulk of which (Rs. 29 million) was from tobacco tax.

The total voted expenditure in 1967/68 is provisionally estimated at Rs. 2,900.6 million; this was Rs. 38.9 million more than the original estimate. There was an increase of 12.1 per cent in total expenditute compared with an increase of 5.9 per cent during the last decade. Recurrent expenditure comprised 72.7 per cent of the total voted expenditure while the capital expenditure accounted for the balance. The annual average increase in capital expenditure was 8 per cent over the last ten years; recurrent expenditure rose by 6.6 per cent annually. The capital expenditure of the Government was estimated at Rs. 793 million, the bulk of which was directed towards the agricultural sector (32.2 per cent) and the provision of social infra-structure (24.7 per cent). An amount of Rs. 108.4 million is included in this total as capital expenditure of enterprises.

In 1968, capital expenditure increased by Rs. 90 million over the previous year. As in previous years there was a shortfall in voted capital expenditure which in 1967/68 amounted to Rs. 124.1 million. Due largely to improvements in implementation the under-expenditure had dropped from 21.0 per cent in the previous year to 14.8 per cent.

In total current expenditure, transfer payments (food subsidy, interest on public debt, pensions etc.) constituted 35.6 per cent of the total. Gross food subsidy, which consisted of the consumer subsidy (on imported rice) of Rs. 295.9 million and a producer and consumer subsidy (on local rice) of Rs. 236.1 million in 1967/68, registered a sharp increase from Rs. 465.5 million to Rs. 589.4 million. After allowing for profits on the sale of sugar, flour and a few other items, the net subsidy increased by Rs. 104.5 million (or by 54.1 per cent). Though the quantity of imported rice fell during the year there was a sharp increase in the import price of rice by 51 per cent from Rs. 654 to Rs. 988 per long ton. Besides, there was also an increase in the guaranteed price (from Rs. 12 to Rs. 14 per bushel of paddy). Although the issue of local rice under the ration declined from 238,159 tons to 210,000 tons (by 12 per cent) the rise in price was by a higher percentage (16.6 per cent). It need hardly be emphasised that in a country like Ceylon which has embarked on social welfare programmes on education, health, food, etc. there is an inevitable increase in current expenditure due to growth of population.

The net expansionary effect of budgetary operations is a measure of the extent to which Government activity absorbs more of the national output, than what taxation and public loans could adequately cover and provide. The use of additional resources by Government not counteracted by a decrease in private consumption would add to the expansionary forces.

The net cash deficit which represents the changes in the cash balances less net receipts (or payments) on account of borrowing and lending operations and foreign grants reached the highest figure of Rs. 715.7 million ever recorded. A rise in recurrent and capital expenditures and advance account operations, offset to some extent by increased revenue collection had the effect of raising the net cash deficit to a new high. The sources of financing this deficit are shown in Table I-2. Evidently, domestic market borrowing from the banking system (mainly from Central Bank) had been the main source of finance, accounting for nearly 42 per cent of the net cash deficit. As at September, 1968, Central Bank holdings of Treasury Bills was 91 per cent of the total of the authorised limit of Rs. 1,750 million. Market borrowing from non-bank sources tends to reduce the liquidity of the private sector and this method of financing which comprised 35 per cent of the net cash deficit is the least expansionary. The Government had recourse to foreign borrowing mostly in the form of project loans and commodity loans; its share was 26 per cent of the total net cash deficit. (At the same time there was an increase in cash balances.) This method of financing is not expansionary because it augments the real resources of the country through imports. Use of counterpart funds and drawing down cash balances are expansionary at the time of their utilisation.

In fact counterpart funds represent amounts due from Ceylon for which goods have already come in. When goods have arrived there is a deflationary situation as the money for the goods are credited to a counterpart fund. But when these funds are being utilized they have an expansionary impact.

TABLE I - 2

Financing of the Deficit 1963/64 to 1967/68

Rs. Million

Source	1963/64	1964/65	1965/66	1966/67	1967/68 (provisional)
1. Total financing from non-bank sources	301·1	393·2	486·1	577·9	448.3
(a) Domestic non-market borrowing	— 1·9	50·3	112·2	72·3	9·8
(b) Domestic market borrowing from non-bank sources ..	207·6	243·2	255·9	297·0	248·3
(c) Foreign loans and grants ..	95·4	99·7	118·0	208·6	190·2
2. Domestic borrowing from the banking system	115·2	17·7	162·3	51·3	303·5
3. Use of Government cash balances and commodity aid counterpart funds					
(a) Cash balances	45·4	19·5	- 47·2	21·5	— 48·4
(b) Commodity aid counterpart funds	–	–	- 35·2	— 43·9	12·3
4. Total net cash deficit ..	461·7	430·4	566·0	606·8	715·7
5. Adjustment for change in U. S. Aid Counterpart funds ..	2·3	- 2·5	42·5	27·2	–
6. Net expansionary impact of Government fiscal operations (2 + 3 + 5)	162·9	34·7	122·4	56·1	267·4

On the whole the net expansionary impact of Government operations was very much higher in 1967/68 (by Rs. 211 million) than in the previous year. Foreign assistance and market borrowing from domestic non-bank sources both declined below the previous year's level. In order to encourage the non-bank sources to supply a larger volume of money to Government operations through Government securities the Government implemented the recommendation of the Monetary Board to raise interest rates from $4\frac{1}{2}$ per cent to $5\frac{1}{2}$ per cent on long term (21-25 years) loans. The decline in the amount contributed to Government securities may be due to the availability of avenues for industrial and other investment, in the private sector. This combined with a decline in the amount of foreign loans and grants resulted in the Government having to increase its borrowing by as much as Rs. 176.4 million from the Central Bank.

At the time the Budget was prepared the anticipated budget deficit for 1967/68 was Rs. 768.1 million while the estimated net cash deficit (after adjusting for sinking fund contributions and direct repayments of public debt) was Rs 642.5 million. The following table gives a comparison of data of the original estimate with the actual (provisional) estimates, for 1967/68.

TABLE 1-3

Financing of Net Cash Deficit 1967/68

(i.e. Budget Deficit less sinking fund contributions and direct repayments of public debt and special payments.)

Rs. Million

Source	Original (Anticipated)	Actual (Provisional)	Excess or shortfall (—)
1. Foreign finance (Commodity & project aid) ..	224·4	190·2	— 34·2
2. Local loans			
(*a*) Market borrowing from non-bank sources ..	275·0	248·3	— 26·7
(*b*) Non-market borrowing	47·0	9·8	— 37·2
3. Total	546·4	448·3	— 98·1
4. Net cash deficit	642·5	715·7	+ 73·2
5. Bank Borrowing (4–3)	96·1	267·4	171·3

The anticipated net cash deficit was to be financed mostly from non-expansionary sources leaving an unbridged gap of Rs. 96.1 million from expansionary bank borrowing. There was however, a shortfall of Rs. 98.1 million from non-expansionary sources and an increase in the net cash deficit itself by Rs. 73.2 million. Thus, total borrowing from expansionary sources increased by Rs. 171.3 million.

Since the introduction of the budget of 1967/68 two important decisions changed the structure of revenue and expenditure. One was the devaluation of the Ceylon Rupee in November 1967 and the other was the introduction of the Foreign Exchange Entitlement Certificate Scheme. To soften the impact of devaluation an interim allowance to certain categories of employees was paid thus increasing the recurrent expenditure by Rs. 65 million.

The larger net cash deficit resulted mainly from an increase in the net food subsidy by Rs. 80.0 million due to a sharp increase in the price of imported rice; an increase of Rs. 65 million in allowances due to the granting of an interim allowance to certain categories of Government employees following on the devaluation in November 1967. In 1967/68 Government retired Rs. 21.6 million of food import bills held by the banking system. This increase in expenditure was only partly offset by an increase of revenue by Rs. 106.5 million over the anticipated figure.[1]

1. At the time the budget was prepared the anticipated revenue was Rs. 2,049.9 million.

The expansionary impact of Government operations affects the money supply directly by increasing the liquidity of the system; the general level of prices by placing extra purchasing power in the hands of the public, and creates additional pressure on balance of payments through leakages into imports.

The net expansionary impact of Government operations would have led to serious monetary expansion but for mitigating factors such as the satisfactory growth in real product and the reduction in external banking assets.

The net cash deficit of the Budget for 1968/69 (approved by Parliament in September 1968) is expected to be Rs 701.2 million. The Government proposes to finance this deficit largely from non-expansionary sources and only Rs. 11.5 million is expected to be financed from bank borrowing. It is however likely that the expansionary effect of the budget would be larger. This needs careful watching especially because the private sector's own credit requirements in the current year are likely to be substantial.

The budget for 1968/69 proposed a few changes in excise duties. Some of the other tax reforms proposed by the Taxation Inquiry Commission[1] would not come into immediate effect.

In the budget for 1968/69 the deficit expected to be financed from expansioary sources is limited to Rs. 11.5 million. Though there are signs that this figure will be exceeded, the ultimate outcome will depend on budgetary management and receipts from aid programmes. The tax system, apart from higher rates has not absorbed a sizeable part of the increase in national product. This is mainly due to concentration of increments of income in rural areas combined with redistribution policies adopted in the past. This new situation calls for a change in the means of mobilisation of resources.

The rate of growth of income enlarges the tax base. A developing country such as Ceylon cannot place heavy reliance on direct taxes. At the same time heavy dependence on Customs duties as the major source of revenue tends to reduce the elasticity of public revenue. Cost or quantitative restrictions on imports and declining prices for exports are likely to reduce the importance of customs duties as a major source of revenue. Accordingly, the turnover tax is increasingly becoming an important source of revenue. This emphasises the need to resort to indirect taxes not only to siphon off a part of the increased incomes at the time of spending but also to allow free market forces through the cost structure to play its major role in the allocation of resources. Taxes on expenditure favour savings, thereby inducing growth. A consumer has the choice of postponing the payment of tax by reducing consumption and earning an income (interest) on the amount thus saved. These indirect taxes falling as they do on consumption discriminate against low savers in favour of high savers. Alongside this measure, the use of prices as a deliberate steering mechanism not only allocates resources efficiently but also controls excess demand by absorbing a part of it.

1. Report of the Taxation Inquiry Commission, Ceylon Sessional Paper No. 10 of 1968, Government Press, Colombo 1968,

The Committee on Pricing Policies appointed by the Cabinet Planning Committee in December 1965 issued its report in December 1966. This committee examined the pricing policies pursued by State Enterprises. It was observed that the State had no clear-cut pricing policy for products and services of most corporations; where a corporation had such powers, political considerations have taken precedence over the promotion of economic viability of the enterprise; in some other cases, evolution of a policy had been prevented because of considerations of public interest. The committee recommended that the prices be fixed so as to ensure a minimum return (at least one per cent above the Government borrowing rate) after payment of all taxes.

2. Commercial Bank Credit to Private Sector

There was a large increase of Rs 291 million in commercial bank credit to the private sector in 1968 compared to an increase of Rs 105 million in 1967. This was the highest ever recorded in recent years. The largest increase in advances was in the category of loans; there were also substiantial increases in overdrafts, import bills and export bills. The increase in end-year figures of credit outstanding was mainly accounted for by advances to the industrial and commercial sectors. In the field of agricultural credit, the gross volume of loans extended by banks for the Maha 1967/68 and Yala 1968 seasons under the new Agricultural Credit Scheme was higher than that for any year under previous schemes. The rise in agricultural loans has been matched by an increase in output and has been accompanied by a larger degree of monetization of the rural sector. The following table gives a summary of commercial bank advances to the private sector.

TABLE I - 4

Commercial Banks' Advances to the Private Sector

Rs. Million

Item	End of December			Change 1967/68
	1966	1967	1968	
1. Cash items in process of collection(*a*)	107·1	56·9	52·5	− 4·4
2. Local bills	–	–	0·1	+ 0·1
3. Import bills	35·3	55·6	89·4	+ 33·8
4. Export bills	52·4	53·4	80·2	+ 26·8
5. Overdrafts	391·9	418·9	497·8	+ 78·9
6. Loans	338·1	444·8	600·7	+155·9
Total	**924·8**	**1,029·6**	**1,320·6**	**+291·0**

(*a*) Thiscategory contains only a small element of inter-bank debt represented in cheques sent for collection. It consists mainly of very short-term advances granted to Co-operatives for the finance of purchases of foodstuffs under the Guaranteed Price Scheme and purchased cash items.

The volume of bank credit outstanding reached a peak in 1968. There were significant changes in the pattern of credit. Advances for industrial purposes increased appreciably in volume and in relation to total credit. Within the category of commercial advances, there were increases in credit for export trading as well as for imports of intermediate goods, such as fertilisers. The expansion of agricultural credit has already been referred to and is dealt with in detail in a later section. There was a decline in advances for consumption purposes and their weight in total advances fell significantly.

3. Money Supply

Between the end of December 1967 and end of December 1968 the money supply increased by Rs 106 million or 5.8 per cent as compared with 9 per cent during the previous year. The rise in the average monthly level was, however, higher amounting to 6.9 per cent in 1968 as against 2.7 per cent in 1967. The ratio of Gross National Product to money supply increased from 4.7 in 1967 to 5.3 in 1968, and was accompanied by an increase in the turnover rate of demand deposits from 1.60 in 1967 to 2.06 in 1968.

Table I-5 depicts the factors contributing to the changes in money supply between the end of December 1967 and the end of December 1968.

TABLE I-5

Changes in Money Supply

(End December 1967 to End December 1968)

Rs. Million

Factors Affecting Money Supply	Amount	
1. Expansionary factors:		
(a) Commercial bank credit to the private sector* ..	173·5	
(b) Commercial bank credit to Government Corporations ..	90·6	
(c) Credit to Government from the banking system ..	192·0	
(d) Adjustments	0·2	456·3
2. Contractionary factors:		
(a) Decrease in External banking assets (net) ..	115·7	
(b) Increase in time and savings deposits of the private sector*	101·4	
(c) Increase in time and savings deposits of Government Corporations	23·2	
(d) Increase in other liabilities (net) of commercial banks ..	40·9	
(e) Increase in Government cash balances ..	69·4	
(f) Increase in other liabilities and accounts (net) of Central Bank	0·2	350·8
3. Increase in Money Supply		105·6

* Includes Co-operatives

The major factor affecting the growth of money supply was the expansion of credit to Government and Government corporations. Credit to Government increased by Rs 192 million, but nearly one-third of the increase was offset by an increase in Government's cash balances, largely in the form of counterpart funds.

A comparison of the budget data of Table I – 2 with the money supply data given above indicates that the Government budgetary operations led to a large-scale borrowing from the Central Bank, a large portion of which was used to retire Government import bills held by commercial banks. It should be noted that the retiring of import bills has an expansionary impact as it involves drawing down cash balances or resorting to Central Bank credit. Resort to this type of credit would involve financing of the budget deficit through commercial bank credit. [1]

Commercial bank credit to the private sector (excluding Government corporations) increased by Rs 174 million but was offset to a large extent by an increase in time and savings deposits by Rs. 101 million, and an increase of Rs. 41 million in 'other' liabilities (net) of commercial banks, thus giving a net expansionary impact of the private sector of Rs. 32 million. Government corporations contributed to the expansionary impact by increasing their borrowing by Rs. 91 million from the commercial banks, which was partly offset by increasing their time and savings deposits by Rs. 23 million.

The contractionary effect of a decrease in external bank assets of Rs. 116 million reduced the impact of expansionary forces generated by Government and private sectors, all of which contributed nearly Rs. 223 million to expansionary pressures.

(c) External Payments in 1968

The balance of payments situation continued to be under strain and was associated with a sharper deterioration in the terms of trade than in the previous year. Price trends in rupee terms have been favourable but foreign price of tea actually fell.

The export earnings, both visible and invisible, rose from Rs. 1,912 million in 1967 to Rs. 2,229 million in 1968, an increase of 16.6 per cent. Imports rose faster by more than 17.0 per cent from Rs. 2,201 million in 1967 to Rs. 2,575 million in 1968. The deficit in the balance of payments on account of these current account transactions was Rs. 57 million higher than in the previous year. Table I – 6 shows the methods of financing the balance of payments deficit.

---

1. In the Government budget which gives an estimate of revenue and expenditure, these import bills are not introduced as a part of Government expenditure and thereby excluded as a source of financing the Government deficit from the banking system. As a result, during the years in which this credit has increased the total deficit is understated, and also its expansionary impact, and during the years in which such credit is reduced the deficit is overstated. In the analysis of money supply these import bills are recorded as part of credit to Government from the banking system. The changes in the Government debt to the banking system reflect only a part of the influence of Government measures on domestic demand. The budgetary operations are shown in a section on the Government Budget.

TABLE I—6

Ceylon's Balance of Payments 1963-1968

Rs Million

Item	1963	1964	1965	1966	1967	1968 *(a)*
1. **Merchandise**						
Exports, f. o. b.	1,708	1,767	1,909	1,674	1,650	1,975
Imports, c. i. f.	-1,869	-1,960	-1,922	-2,018	-1,985	2,341
Trade Balance	- 161	- 192	- 13	- 344	- 335	- 366
2. **Services**	- 20	- 7	31	16	24	- 3
3. **Transfer Payments**	13	40	40	37	22	23
4. **Current Account Balance**	- 168	- 160	59	- 290	- 289	- 346
Method of Financing						
5. **Private Capital**						
(i) Long-term	+ 5	+ 1	- 4	- 16	- 6	- 12
(ii) Short-term	- 5	- 9	- 18	- 18	+ 8	- 7
6. **Offical and Banking Capital** (*b*)						
(i) Change in net external long term liabilities	+ 75	+ 7	+ 36	+ 153	+ 167	+ 236
(ii) Change in net external short term liabilities	+ 46	+ 59	+ 22	+ 71	+ 269	+ 174
(iii) Change in external assets	+ 42	+ 111	- 89	+ 122	- 131	- 14
(iv) Other	—	—	—	- 2	- 6	- 6
7. **Errors and omissions**	+ 4	- 8	- 6	- 16	- 12	- 25

(a) provisional
(b) A plus sign represents a decrease in assets or an increase in liabilities.

Imports in money terms rose faster than the rise in Gross National Product mainly due to devaluation. The proportion of imports in consumption was higher in 1968 than in the previous year; the import coefficient of private consumption rose from 0.15 in 1967 to 0.17 in 1968 and that of capital formation from 0.23 to 0.24. Liberalisation of imports together with the price increase caused by devaluation raised the dependence on imports. In the context of a rising import coefficient it is noteworthy that the repercussions on the balance of payments situation did not make the deficit very large. This was due to a rise in the export earnings in rupee terms after the devaluation. Exports rose by Rs. 345 million. The balance of trade however was unfavourable. In this, the effects of three factors — price, volume and terms of trade — are mixed up. Since the foreign price of tea fell, the price effects and terms of trade effects can be considered as being due to devaluation effects, while the volume increase stands on its own. It is to be noted that the volume of tea exports actually fell; the existence of bilateral agreements to the purchase of rubber poses no problems in the sale of the entire output of rubber; volume effects of coconuts and coconut products give only a small weightage in the export earnings.

The foreign exchange budget for 1968 had to be substantially modified after the introduction of the FEEC Scheme. The original budget was based on an export forecast of Rs. 1,950 million but the actual export earnings (including re-exports) amounted to Rs. 2,035 million. It had been emphasised that this satisfactory performance in export earnings was mainly due to devaluation effects which resulted in prices rising by 20 per cent; this was accompanied by a small increase in volume.

The import programme had to be revised in May 1968 to take into account the classification of goods into 'A' and 'B' categories. A resource allocation of Rs. 2,234 million was envisaged by the original import programme. Subsequently, after the exchange reforms, this was stepped up and by the end of December 1968 licences issued on 'A' category items amounted to Rs. 2,256 million while a further amount to the value of Rs. 327 million was issued on 'B' category imports. The letters of credit opened for goods under Open General Licence in the 'B' category amounted to Rs. 308 million.

The total external resources available to finance this import programme was Rs. 2,811 million. This included export earnings of Rs. 1,975 million; official capital inflow of Rs. 340 million (of which loans including commodity aid Rs. 295 million, grants Rs. 42 million) drawings from the International Monetary Fund net of repurchases amounting to Rs. 165 million, an increase in indebtedness to bilateral partners (Rs. 42 million) and short term borrowing from foreign banking sources (Rs. 29 million). Of the total licences issued and letters of Credit opened for OGL items an amount of Rs. 120 million was outstanding at the end of the year.

The International Monetary Fund was the principal source for short term funds. During the year Rs. 213 million was drawn ; Rs. 115 million under the scheme for Compensatory Financing of fluctuations in export financing ; Rs. 98 million under the Third Standby Arrangement entered into on 5th May 1968 immediately before the FEEC scheme was introduced. A repurchase of Rs. 48 million reduced the net drawings to Rs. 165 million compared with the net drawings of Rs. 105 million in 1967.

Due to various borrowing arrangements and drawings from the International Monetary Fund the external assets (net of Sterling loan sinking funds) increased from Rs. 407.0 million in 1967 to Rs. 417.4 million in 1968. The international reserve of the Central Bank, however, declined from Rs. 260.4 million in 1967 to Rs. 235.5 million in 1968, but commercial bank foreign balances and those of Government and Government Agencies increased from Rs. 119.9 million to Rs. 157.3 million and from Rs. 68.6 million to Rs. 70.2 million respectively.

The Central Bank has negotiated substantial foreign exchange credit facilities with a number of banks abroad.

(d) Prices

Though the supply situation was better in absolute terms in 1968 than in 1967 there were shortages in supply relative to demand. The cumulative effect of this excess demand exerted pressure on prices which, according to the Colombo Consumers' Price Index, rose by 5.9 per cent. It was noted elsewhere that this index does not reflect the actual rise in prices. As far as the consumer price index was concerned the price control measures, rationing and subsidisation of essential foodstuffs and textiles had checked the prices from rising.

But, the inflationary pressures affected different sectors and different classes of consumers in an uneven way. Generally the greatest pressure has come from manufactures. Imported articles which were in short supply had shown a large price increase over the past few years; their prices climbed higher in 1968 after the exchange rate depreciation and the subsequent reforms in the exchange system. The prices of import substitutes moved up as the level of protection given to them increased by these changes. The exchange reforms adopted in May 1968 had the effect of bringing down the prices of some commodities with an elastic demand and where the proportionate increase in supply was almost equivalent to the proportionate increase in demand and where it was uneconomic to carry large stocks.

When either the consumers, investors or the Government attempt to obtain a larger share of the increase in output than what they could obtain under normal utilisation of their increased income and income distribution, the pressure on aggregate demand will build up inflationary tendencies in the economy; the cumulative effect of their operations would cause the inflationary gap to widen.

Consumers and businessmen react differently to an increase in prices. The wage earners would demand an increase in wage rate to ward off some of the adverse effects that inflation has on their level of living. Increases in wages will have to be matched by the increase in productivity or else the extra spending power will cause prices to rise further.

The impact of the monetary expansion cannot be measured in any precise form for lack of a reliable indicator. It was mentioned earlier that the Colombo Consumers' Price Index rose by 5.9 per cent; the implicit price index used for national income calculations rose by 11 per cent. The backlog of effective demand combined with the shortage of supply would result in price increases as long as domestic output does not respond proportionately or imports increase in the same proportion to meet the excess demand. The growth of output in the agricultural and industrial sectors had been remarkable in 1968, but the aggregate demand had been of such a magnitude that this increase of output was not adequate to ward off any increase in price. In the circumstances, the monetary expansion would exert pressure on prices unless consumption and probably investment are kept in check. But a curtailment on investment is not a healthy measure for a growing economy, and alternative steps have to be taken in the monetary and fiscal fields until real product increased in proportionate terms to meet the aggregate demand.

B. Survey of Selected Sectors of the Economy

(a) Agriculture

The contribution of the agricultural sector to the national economy continued to remain at a high level in 1968. The growth rate in this sector, which had been below that of Gross Domestic Product from 1963 to 1966, reversed its trend, and in both 1967 and 1968 it stood well above the growth rate generated by Gross Domestic Product.

The retarded rate of growth of major exports was a matter of concern in view of its importance as the major provider of foreign exchange. Over the last eight years, the compound rate of growth rose by less than 2 per cent. The major exports pose special problems of declining prices. Joint efforts by the producer countries to stem this falling trend in prices include joint study groups for rubber for purposes of increasing productivity and reducing costs; joint marketing schemes for tea; and the establishment of a coconut community to promote research and marketing in this product. These products are normally marketed through traditional channels and the breakthrough into new markets has been of little significance. International action both by consuming countries and by producing countries is required to remove impediments to the expansion of exports by way of import duties or the existence of 'captive markets' as in the case of synthetic rubber.

In the field of agricultural production for domestic use the rural orientation of economic policy was continued on an intensified scale. Public investment in agriculture designed to give better facilities in irrigation, flood control and improvement of agrarian structure accounted for Rs. 254.9 million in 1968. This was an increase of 43 per cent over the previous year. The Government has adopted a conscious policy of encouraging this peasant sector of the economy with a view to the attainment of a better distribution of income, at the same time pursuing a policy of import substitution in agriculture. Since 1966, the imports of rice have fallen from 494,000 tons in 1966 to 381,000 tons and 344,000 tons in 1967 and 1968, respectively. Unfortunately, there was a sharp increase in the price of rice by 57 per cent, which more than offset the savings due to a reduction in the volume of imports by 10 per cent.

The agricultural programme is mainly designed to achieve self sufficiency in the non-export agricultural products of rice and subsidiary food crops. This year rice production reached a peak level of 64.6 million bushels of paddy (rice equivalent of 900,000 long tons) compared to 55.1 million bushels (769,000 long tons of rice) in the previous year.

The marked increase in output was largely the result of incentives given to the farmer in the form of improved agricultural inputs, price incentives and institutional credit. The operation of the fertilizer subsidy and credit facilities has resulted in an increase in the consumption of fertilizers by 30,000 tons in 1968. The increase in the guaranteed price of rice from Rs. 12 to Rs. 14 per bushel after the devaluation in November 1967, has given an incentive to increased production and an assured market to paddy farmers. The open market price in 1968 has been above the guaranteed price. The average price of a measure of rice under the guaranteed price scheme was 90 cents but the average open market price was much higher during a certain season at the consumption centres. The average open market price was above the guaranteed price despite a sharp increase in domestic production mainly because the supply of all cereals was still short of demand (including stocks) by nearly 194,000 tons.

The demand for rice has been suppressed by two factors — one was the cut in the ration which made only a limited quantity available free; and the other the rise in prices which reduced the consumption of rice by a class of consumers whose incomes were low. Thus, when incomes rise, consumption is expected to go up at least to the old level, but the pressure of demand on existing supplies would tend to push up prices. At the same time there was an increase in supply as a result of increased production but this increase was insufficient to meet the local demand position. Total domestic production at 64.6 million bushels of paddy (less seed paddy) gives a rice equivalent of 858,000 tons. Imports in 1968 amounted to 344,000 tons of rice and 359,000 tons of flour. The total cereal supply adjusted for stocks at 1,494 thousand tons was about 90 per cent of the estimated demand for cereals of 1,660 thousand tons.[1] Inevitably, the only response to the growing pressure of demand (with supplies short of demand) has been a rise in retail prices of open market rice. It is not known how much the farmer himself consumes out of his production. The indications are that as his income rises, he will consume more out of his production than before because of the ration cut, thereby reducing the quantity of rice available in the open market.

The transformation of the traditional form of agriculture has brought about significant changes not only in output and yields but also in the achievement of self reliance and steady economic growth. The expansion of non-export agricultural output by Rs. 153 million in 1968 has contributed 23 per cent to the rise in national product. Despite a rise in rural incomes over the last three years there has not been an appreciable increase in rural savings. The increase in time and savings deposits of rural banks was only Rs. 1.8 million in 1968. There was, however, an increase of Rs. 12.4 million in deposits with the Post Office Savings Bank which is the traditional form of channelling rural savings. There was also an increase of Rs. 13.1 million in the savings deposits of branches of commercial banks in rural areas.

The supply of credit to the rural sector will have to be augmented further in order to help the farmer reach the target of realising self-sufficiency in rice production and in subsidiary crops. The extension of credit is matched by an expansion of output and productivity but the additional incomes in the hands of the farmer could be wasted in expenditure that is so customary in rural areas. This addition to aggregate consumption will cause inflationary pressures. The extension of the banking system and other institutions for the mobilisation of savings in rural areas therefore becomes an urgent necessity.

---

1 Based on a per capita rice consumption of 114 measures and 82 lbs. of flour for a year.

The system of rural banks was conceived a few years ago as a means of extending banking services in rural areas. Under this scheme, when selected multipurpose co-operative societies are allowed to accept time and savings deposits, they are called rural banks. These rural banks, primarily because they are co-operative societies, lack depositors' confidence and the prosperous farmers prefer to invest their surplus funds in physical assets. The development of rural banking depends on a complex of factors such as depositors' confidence, progress of banking habits, profitability of this commercial activity, the service it can provide, and its ability to work within the social framework that is peculiar to a particular area. One preliminary step in the right direction can be taken by these rural banks by seggregating the customers' deposits and managing the money on strictly banking lines. Owing to the present weaknesses in the management of some of the co-operative societies, it is doubtful whether co-operatives can attract funds as well as lend funds to and from members. To win the confidence of the depositors a rural bank has not only to assure the safety of the deposits through a deposit insurance scheme but also provide credit for productive purposes while at the same time give them limited accommodation for certain consumption purposes.

The agricultural credit function could then be gradually taken over by these rural banks. Nonetheless the need to provide medium term and long term agricultural credit will be even greater and the reorientation of lending policies towards the achievement of a major transformation in agriculture and its transition to the establishment of agro-oriented industries would call for a major overhaul in lending policies. The proposed Development Bank could not only serve the needs of the agricultural sector but also of the expanding industrial sector by actively promoting and assisting the economically viable projects. These agricultural loans could then be extended for an expanded programme for the production of livestock products. In any case fresh impetus is needed in the supervision of the credit scheme so that a fair proportion goes into agriculture where attempts are made to relate credit to output thereby improving resource use and raising production and income.

Inherent tendencies stemming from legacies of the past are mainly responsible for most of the shortcomings, which are a part of the much larger complex of problems deeply rooted in tradition. Changes that can be introduced and absorbed will depend on the rate at which the economy itself is changing its structure on the identification of problems and on the support that corrective measures can give in facilitating balanced growth.

(b) Manufacturing

Since the manufacturing industry comprises only a small proportion of Gross Domestic Product (7 per cent in real terms) the broad strategy of a developing economy is to push ahead the development of a sizeable and modern manufacturing industry. The concern with maintaining a certain degree of sectoral balance between agriculture and industry is essentially a short term requirement.

Agriculture uses a large variety of inputs from industry. Higher the degree of modernization in agriculture the higher will be the volume and value of inputs originating in industry. According to a recent survey on cost of production of paddy conducted by the Central Bank of Ceylon, on the average nearly 24 per cent of the acreage in Ceylon is mechanised. As agriculture gets mechanised and modernised, repair services, and construction and other ancillary activities will spring up. Specialisation will increase and those industrial activities that were done on the farm will then be done in the industrial sector.

The agricultural sector had three continuous prosperous years. The need to tap the increased incomes of this sector assumes a place of special significance because of the shift of incomes towards the agricultural sector. At the same time their consumption will grow and the demand for certain types of industrial goods (clothing, food, tobacco etc.) will grow even faster.

The survey of industrial production conducted by the Central Bank lends support to the view that import substitution in industry has paid dividends. Industrial employment increased by about 36 per cent; labour input (number of man-days) by 42 per cent; output per man-day rose by 25 per cent.

There was an increase in overall productivity. Since 1965 there had been a growing trend towards increasing productivity in most branches of industry. This was mainly due to an expansion of the domestic market consequent to a rise in incomes particularly after 1966 and a higher rate of plant utilization. In 1964, the foreign exchange constraint adversely affected the manufacturing industry; this together with an over-valued rate of exchange, inflated investment cost and production costs and the presence of idle capacity led to a slow rate of growth at the beginning of 1965. But impressive increases in production were observed soon after, mainly due to larger foreign exchange allocations, fuller utilization of productive capacity and entry of new industries. Quantitative restrictions and industrial allocations can lead to discriminatory limitations and the growth of uneconomic industries in the long run. The introduction of the Foreign Exchange Entitlement Scheme removes such barriers and allows market forces to allocate the resources and aid the emergence of a viable industrial sector.

The expansion of output in general and the increase in industrial exports in particular in 1968 had been supported by government policies adopted in recent years. Industrial sector can grow rapidly but the inward looking import competing industries had to be reoriented with a view to exporting a diversified output.

C. POLICIES AND MEASURES

(a) External Payments and the reform in the Exchange System

The continuous drain on foreign exchange reserves of Ceylon caused by persistent deficits in the balance of payments precipitated a crisis which reached a peak in the first quarter of 1964. Except for a small surplus in 1965 brought about by stringent import controls, and an exceptionally good performance in the export sector, the balance of payments continued to register a deficit up to 1968. The pressure on the balance of payments originated mainly in a rapid growth in consumption (including import oriented) expenditure which grew faster than exports. Betwen 1959 and 1967 consumption expenditure (private and public) rose by 40 per cent while exports rose only by 10 per cent. A larger volume of imports of intermediate and investment goods was required to sustain the programme of import substitution in particular and economic development in general. But the exchange reserve position especially in 1964 and 1965 did not permit of even a moderately liberal importation of these goods thus causing a further fall in domestic production. At the same time export earnings continued their downward trend. Alongside this, the import expenditure induced by a high rate of consumption and the requirements of development continued its upward trend.

An over-valued exchange rate distorted the relationship between domestic and foreign prices making imports cheaper and exports more expensive. Falling export prices of major commodities coupled with a high degree of inflexibility in its productive structure reduced the annual export earnings below the level of imports. Inward looking import substitution industries even though some of them relied heavily on imported raw materials and required only a small conversion of inputs domestically had to be supplied with foreign exchange to enable them to operate not very far below the technically achievable output level. The foreign exchange reserve position was so acute by 1964 that a deviation from this normal policy was inevitable and the industries were required to adjust themselves to the realities of a foreign exchange constraint.

In a situation of this nature, where the working of the market mechanism had been severely distorted, the development of import substituting industries is hampered without the normal protective arm of a realistic exchange rate. The over-valued exchange rate had not only retarded the growth of the economy but also caused a rapid drain on foreign exchange reserves. The level of reserves had dwindled from about 54 per cent of the value of import in 1957 to about 20 per cent by 1967. Changes in the capacity to import as shown by the following table had been such that a large resource gap had developed and imports that were required for essential consumption and of investment had to be financed by foreign assistance, an extensive drawing down of foreign reserves and an increase in short term indebtedness.

TABLE 1 — 7

Capacity to Import - 1959 Prices

Rs. Million

Year	Domestic Exports	Terms of Trade	Net Capital Movements	Net Factor Payments	Capacity to Import	Actual Imports
1960 ..	1777	— 11	2	— 44	1724	1939
1964 ..	2060	— 316	2	— 34	1712	1870
1966 ..	1928	— 505	— 12	— 36	1375	1740
1967 ..	2002	— 667	— 2	— 45	1288	1442
1968 ..	2022	— 821	— 4	— 39	1158	1385

Evidently, actual imports have been far in excess of the capacity to import. In the circumstances, there was bound to be a continuing foreign exchange problem. In the absence of adequate reserves the resource gap is being met largely through foreign borrowing. This method would help in meeting the immediate problem. Nevertheless, it would create even larger resource gap in future due to debt servicing unless the borrowings are utilized in a manner that would tend to increase exports or reduce imports or both.

The dwindling import capacity in relation to actual import requirements, the existence of an active blackmarket in foreign exchange and the heavy reliance on more and more stringent controls were all indicative of an unrealistic rate of exchange.

The Rupee was devalued by 20 per cent in November 1967, but it was felt at that time that, while the new rate was a good basic rate, it was not sufficiently realistic to permit the liberalisation of a substantial range of imports. A unitary rate at a further depreciated level might have met the situation in some respects, but in other respects it might have created further difficult problems in the domestic economy. Thus, for instance, a 20 per cent devalution was felt to be adequate to meet the problems of major exports but was clearly unsuitable to meet the problem of other exports. Similarly, on the import side, while a 20 per cent devaluation gave a sufficient mark up in the costs of a wide range of essential imports, it was insufficient to permit an adequate liberalisation of imports, especially for growing sectors of the economy. Hence, some system of multiple rates appeared to supply the answer to Ceylon's problem.

A bonus voucher scheme of very limited applicability had already been in force in Ceylon since 1966. The experience of this scheme in Ceylon and elsewhere seemed to support the view that in the prevailing circumstances the introduction of a dual rate of exchange would provide more effective measures for export promotion and expansion than a more depreciated unitary rate. It was mentioned in the Annual Report for 1967 that, though devaluation would provide some additional incentives to producers, these would be inadequate for Ceylon's minor exports to break into highly competitive markets. A multiple rate of exchange has the further advantage that the pricing of exports and imports should be more realistic than under a unitary system

In fact, the import substitution schemes in the past had created the necessary psychology and the capacity for a rapid expansion in production in the agricultural and industrial sectors. It is mentioned elsewhere in this Report that agricultural production for domestic use rose by 29 per cent in 1968, while industrial production rose by 47 per cent. Manufacturing exports can be expanded under subsidies when competition in other markets is keen. A realistic exchange rate can achieve the same objective in a more simple way. It should however be noted that an exchange rate reform can promote exports only in a relatively stable framework of domestic prices. A rise in domestic prices of essential commodities will push up wage and other costs and if monetary expansion goes on unrestricted it will result in persistent inflation.

It was found necessary to have at least two rates-one an "official" exchange rate applicable to essential imports and, major exports, the other a "floating" rate or a second rate applicable to all other exports and imports. It was in this context that the Foreign Exchange Entitlement Certificate Scheme was introduced. The Scheme had two main objectives; one was to promote and diversify exports, the other was to liberalise imports by allowing the market mechanism to regulate the flow of imports rather than to rely on quotas and stringent controls to regulate the supply of goods in the face of falling foreign exchange reserves.

Imports were categorised broadly into three groups, the details of which are discussed in another part of this Report.

The Government in consultation with the International Monetary Fund introduced the Foreign Exchange Entitlement Certificate Scheme with effect from May 6, 1968. This Scheme is operated by the Central Bank.

For the first time an attempt is being made through the exchange rate to provide incentives to selected growth sectors with export potentialities and to infuse greater dynamism to import competing industries. The objective in respect of import competing industries was to aid the achievement of long-term viability of enterprises by basing the import of raw materials, machinery, and technical know-how on a realistic price of foreign exchange and to ensure the smoother flow of imports for such enterprises by a progressive removal of quantitative controls and licensing procedures.

The Foreign Exchange Entitlement Certificate was the instrument designed to provide the cash incentive to selected exports and invisible transactions and to impose an additional Rupee cost on selected imports and invisible payments. All other receipts and payments with the outside world would be transacted at the official exchange rate and have come to be referred to as 'A' category transactions. Transactions governed by the Scheme are referred to as 'B' category transctions and are characterised by an additional rupee benefit or cost as the case may be in the form of the price of the Foreign Exchange Entitlement Certificate. The price of the Certificate was initially intended to be determined by market forces as reflected by tender prices for Certificates offered weekly by the Central Bank. Subsequently, however, the price was stabilised at Rs. 44 per Certificate of a face value of Rs. 100; and has remained at that level, although it is basically a floating rate and is liable to be changed from time to time.

An important aspect of the Scheme was that a substantial range of imports specified in category 'B' were brought simultaneously under Open General Licence, thus removing the existing requirements regarding import quotas and licences. These goods consisted predominantly of raw materials for industry. The payment for these imports was, however, subject to the opening of letters of credit with commercial banks. It was envisaged that this considerable measure of liberalisation would aid the smoother evolution of industries and promote their growth on more efficient lines.

The successful operation of the Scheme needed the implementation of supplementary monetary and fiscal policies. As economic growth, already under way, gathered momentum, it would be essential to ensure that monetary expansion did not follow a course which would be disruptive to economic growth itself. The creation of credit had, therefore, to be restrained so that it did not outstrip the needs of the productive sectors and encourage consumption or the speculative building up of stocks. Credit control, therefore, constituted an essential part of the strategy of the scheme. On the fiscal side, it was sought to eliminate gradually the inflationary impact of Government finance by reducing to a minimum the resort to borrowing from the banking system. Import duties and turnover taxes had to be adjusted to suit the new situation regarding costs and profits.

The introduction of the FEEC Scheme led at the beginning to a high degree of demand for certificates. At the start, with a view to ascertaining the market rate, FEECs were sold on tender, and the price fluctuations were rather wide owing to some confusion and uncertainty in the market at the time of introduction of a new scheme of this type. Later when the nature of the Scheme was understood the reaction was different and the price tended to settle down around Rs. 44 per Re. 100 of Certificates. The introduction of forward sales and purchases of FEECs also helped to bring about more stable conditions in the FEECs market.

The relaxation of some of the quantitative restrictions had to be followed by cost restrictions. The exchange rate was conducive to increasing the range of import competing commodities. But the higher price to be paid for imports curtailed the ability to import, and induced importers to adjust the supply in accordance with the elasticity of demand for the commodities. The price effect would have resulted in lower profits which had been fairly high under the quota system. As competition grows, it is likely that a part of the profits will be passed on to the consumers in the form of lower prices or by keeping the price constant in the face of rising costs. The producers will also be directing their efforts towards improving quality. The process of improving efficiency would be assisted by encouraging sales in competitive foreign markets or permitting small quotas for the import of competing products. The availability of imports at a higher price would make the producers practice economies in the use of raw materials, intermediate, and even investment goods and rationalise the amount of exchange that they would purchase.

Stocking cf goods may have developed soon after the introduction of FEECs because of uncertainties, but this should decline as business confidence in the Scheme develops. Stocks would also become very expensive, as the monetary policy is aimed at making credit for speculative purposes both scarce and expensive. With the present credit ceilings traders will be unable to obtain substantial credit for invertory accumulation. In consequence, any accumulated stocks are likely to be released thus causing a downward pressure on their prices.

The price effect of the FEEC Scheme would depend on the elasticity of demand for particular products. Thus, while some commodities registered price declines some others rose or remained constant. The prices of building materials and sanitary ware fell, the latter falling by a higher percentage than the former; food items such as butter and milk, and other items, such as motor spares, showed a rise.

The domestic cost of some of the inputs of industry rose as a result of the FEEC Scheme. An increase in material costs together with a rise in factor costs after wage adjustments following the devaluation raised the cost structure of the industrial goods. But there was evidence of a rise in productivity; this may have come about as a result of expansion of scale and a higher rate of capacity utilisation.

The FEEC Scheme would have favourable effect on employment and income. It is not possible to measure the full effect of the impact of the FEEC Scheme in this direction. It would depend on (1) expansion of output, capacity utilisation and scale of industrial activity, and (2) an increase in cultivation and the drive towards exports of minor products. Private sector output in the agricultural, industrial, construction and service industries increased sharply as a result of new investments and higher rate of capacity utilisation. Both these factors, which were supported by the FEEC Scheme, would have raised income and employment in those sectors. The secondary and tertiary effects would be felt later and would be largely influenced by changes in the marginal productivity of labour.

The effect of the FEEC Scheme on income may be gauged from the rise in the value added (wages, rent, interest and profit) in manufacturing. In money terms the value added in this sector rose by 18.2 per cent, while in real terms it rose by 11.4 per cent. Notable increases in production were observed mostly in labour intensive groups of industry such as garments and confectionery.

One of the chief aims of the Scheme was to promote exports of minor products. Such exports realised a foreign exchange earning equivalent to Rs. 152.2 million or $ 25.6 million, and was an improvement over the previous year by Rs. 26.3 million or $ 4.4 million. It is too early to assess the effect of the FEEC Scheme on minor exports. Most of the minor exports are agricultural commodities or depend on local agricultural raw materials. The elasticity of supply in these agricultural commodities being low, an immediate expansion in exports would come about largely as a result of diversion of domestic consumption towards exports. In view of the small size of domestic market, such immediate diversion on a substantial scale cannot be expected. Hence the reaction of minor exports to the FEEC Scheme is likely to be somewhat lagged.

Invisible earnings were expected to increase as a result of greater incentives to tourist earnings, private capital and professional earnings. There was a rise in tourist earnings from U.S. $ 0.78 million in 1967 to U.S. $ 1.2 million in 1968. In the period May-December 1968 the U. S. dollar earnings per head as compared with the same period in 1967 had increased by 25.2 per cent from U. S. $ 52.2 to U. S. $ 65.1 per head. Private capital movements increased by Rs. 2.3 million in 1968 or by U.S. $ 349,500. Thus there had been a fairly favourable response to the FEEC Scheme from invisible earnings. On balance, the invisible account showed a credit balance of Rs. 20 million for the year 1968.

The operation of the Scheme from May to December 1968 indicates that nearly 13 per cent of the total merchandise imports in 1968 comprised imports under the Open General Licence Category. Nearly 51 per cent of the Letters of Credit opened up to December 1968 was for manufactured goods, while machinery and transport equipment comprised the second most important category with 24 per cent.

It should be mentioned however that the behaviour of demand for Open General Licence Imports is dependent on a number of significant variables, such as the value of agriculture and industrial production, and of domestic economic activity in general, the rate of monetary expansion and of incomes. A change in any or all of these variables could have a direct effect on the demand for goods in this category. While therefore monetary management is of utmost significance, it would appear that, if there is a significant increase in demand for OGL category imports because of the growth of demand or because of the addition of commodities - the growth of OGL imports would require the most careful supervision. The Foreign Exchange Entitlement Certificate Scheme ensures the availablity of foreign exchange for defined categories of payments. Substantively, this price should be a function of the foreign exchange demanded and supplied in the market. A reduction of the supply of foreign exchange due to adverse world market conditions or a reduction in the competitiveness of exports would have adverse effects on the country's foreign exchange reserves if exchange is continued to be provided at a price that is not in consonance with current conditions in the foreign exchange market. Thus the price of the Foreign Exchange Entitlement Certificates requires the closest possible attention. Simultaneously, complementary measures in the monetary and fiscal field are required to support this Scheme because the effects of such policies on the demand for imports are seen much more quickly in an economy which relies less on controls.

(b) Monetary Policy

Monetary policy in 1968 had to take account of the excessive liquidity in the economy resulting from past expansionary policies arising mainly from deficit budgets, and had also to be oriented towards achieving the objectives of the devaluation of November 1967 and the exchange reform of May 1968. The general direction of monetary policy, in those circumstances, had necessarily to be restrictive. Reserve ratios were maintained at the high levels prevailing by the end of 1967.

Interest Rates too had to be moved up and the increase in Bank Rate from 5 to 5½ per cent signalled the need for an upward adjustment in other interest rates; Commercial banks' interest rates moved up with the increase in the Central Bank rate and, on the initiative of the Central Bank, Government's borrowing rate on long-term securities was increased from 4½ to 5½ per cent. The Treasury

Bill rate itself went up by stages from 3.22 per cent in January 1968 to 3.64 per cent since June 1968. The rate at which the Central Bank itself took up Treasury Bills was moved up from 1 per cent to 2 per cent in November 1968. Fixed and Savings deposit rates rose from $3\frac{1}{4}$ to $3\frac{1}{2}$ per cent and 3 per cent to $3\frac{1}{4}$ per cent, respectively.

The Central Bank also imposed ceilings on commercial bank credit to the private sector, as discussed elsewhere. In taking these measures, the Central Bank was however keen to avoid restricting unduly the growing and vital sectors of the economy. Thus, for instance, credit under the new Agricultural Credit Scheme, the tea factory development scheme, and credit for exports were excluded from the operation of the ceilings. The exclusion of credit to Government Corporations needs some explanation. It would be recalled that these Corporations, which in past years had recourse to the Government for their credit, were required to obtain such credit from the banking system, and to that extent the Government's own credit requirments would have been lower. To have included credit to Corporations within the ceiling initially would have unduly restricted their activities. Consideration would have to be given at an appropriate future date to restricting credit to the Government Corporation sector, especially in view of the substantial expansion of credit to this sector in 1968.

The task of monetary policy in 1968 was made more difficult as a result of an un-budgeted increase in the expansionary impact of the Government's fiscal operations. The Budget for 1967/68 which set out to maintain the expansionary impact within Rs. 96 million ended up with an expansionary gap as much as Rs. 267 million. Part of this increase was due to the effects of devaluation and a greater increase in the world market price of rice than anticipated at the time of the Budget. The grave consequences of such an increase in the expansionary impact of the budget were contained by a decline of external banking assets by Rs. 116 million and by maintaining severe controls on monetary expansion to the private sector. Despite this, the increase in credit to the private sector was at the highest level on record.

Thus, despite the large expansionary impact emanating from the Government sector, the Central Bank was able to maintain a high degree of monetary stability in 1968. The rate of growth of real product in 1968 at 8.3 per cent was higher than the growth in the (end of year) level of money supply which rose by 6 per cent over the previous year. while the increase in money supply in 1968, itself was greater than in 1967, there was a backlog of inflationary pressure emanating from the expansionary policies of previous years. This was reflected in rising prices which, according to the Consumer Price Index, increased by 5.9 per cent. The actual rise in the general level of prices is not portrayed by the Consumer Price Index. Large holdings of liquid assets and high levels of personal incomes with a high propensity to consume exerted pressure on prices. Thus, the implicit price index used for national product computations increased by 11 per cent. The rise in prices in different sectors was uneven; manufacturing and export sectors showed a relatively high increase.

With the adoption of a dual rate of exchange a substantial liberalisation of trade and payments was introduced. But the scope of liberalisation will depend on the extent to which aggregate demand could be met from available resources, necessitating an improvement in the suppy position through domestic production and imports. As mentioned in the previous year's Annual Report, an across the board liberalisation of trade and payments would result in foreign reserves being frittered away without adequate results in output and increased efficiency.

The introduction of the FEEC Scheme was a measure taken, interalia, to replace quantitative restrictions by cost restrictions. The effectiveness of cost restrictions would, however, depend largely on the extent to which monetary and fiscal measures are successful in curbing excessive expenditure. Cost restrictions working through the price mechanism become the allocative force; the authorities influence the quantum and the composition of imports only by raising the domestic cost of a range of imported goods. The price level, in particular the price of foreign exchange, is fundamental to the restoration and maintence of equilibrium in the balance of payments. At the same time, the cost and availability of finance must be such as not to penalise the growth sectors cf the economy. The various sectors would have to compete with each other to secure an increasing proportion of available resources by bidding up their prices, including the price of bank credit. The adjustment of the cost and availabilty of money to the real needs of the economy becomes, therefore, one of the principal and most difficult tasks of the monetary authority.

The economy is as yet highly liquid. The ratio of money and near money to the Gross Domestic Product was 43.8 per cent in 1968. Apart from keeping current monetary expansion within prudent limits, monetary policy would have to see that this excess liquidity does not lead to undue pressure on the balance of payments and on the domestic price level. Thus, even though the monetary performance in 1968 was satisfactory and led to a high degree of stability, there is no-room for complacency. Monetary expansion in the economy would have to be carefully watched and in this connection the need for financial restraint in the Government Budget cannot be over-emphasized.

Conclusion

The satisfactory economic performance in 1968 was mainly the result of expansion in output for domestic use. The rate of economic growth at 8.3 per cent outstripped population growth, and per capita real income grew at an annual rate of 6.1 per cent. There was a high degree of monetary stability, despite an increase in credit to the private sector and a large expansionary impact of the Budget. Though the supply position improved considerably, there were still shortages relative to a higher level of demand in certain sectors of the economy. The price level moved up at a much higher rate than in previous years. The persistent deficits in the balance of payments necessitated the reform of the exchange system. The introduction of the FEEC Scheme was one of the far reaching changes made in 1968. Apart from achieving a more realistic exhange rate, it helped the expansion of industrial output through a greater availability of raw materials and the expansion of minor exports though still on a limited scale. The balance of payments situation, however, in rupee terms was less favourable in 1968 than in 1967, but it showed an improvement in dollar terms. Had the terms of trade not deteriorated there would have been a greater improvement in the balance of payments.

TABLE II (A) 1

Summary Indicators of Product and Expenditure

	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968
A. Values										
1. Gross National Product at Factor Cost Prices (Rs. Mn.) ..	5,893	6,287	6,313	6,503	6,797	7,291	7,484	7,699	8,224	9,809
2. Gross Domestic Expenditure at Market Prices (Rs. Mn.) ..	6,600	6,909	6,939	7,069	7,389	7,958	8,051	8,627	9,317	10,626
3. Private Consumption at Market Prices (Rs. Mn.) ..	4,636	5,020	4,912	5,010	5,339	5,755	5,881	6,274	6,712	7,550
4. Public Consumption at Market Prices (Rs. Mn.) ..	881	911	926	979	1,011	1,090	1,157	1,158	1,228	1,408
5. Gross Domestic Capital Formation at Market Prices (Rs. Mn.) ..	1,113	978	1,102	1,080	1,160	1,113	1,013	1,195	1,377	1,668
6. Exports of Goods and Non-Factor Services (Rs. Mn.) ..	2,016	2,011	1,907	1,971	1,903	1,937	2,095	1,865	1,849	2,165
7. Imports of Goods and Non-Factor Services (Rs. Mn.) ..	2,176	2,209	1,972	2,070	2,031	2,102	2,061	2,155	2,106	2,474
8. Gross National Product per Capita at Factor Cost Prices (Rs.) ..	612	635	621	623	638	669	670	673	703	820
9. Gross Domestic Expenditure per Capita (Rs.) ..	689	698	683	677	705	730	721	754	796	888
10. Gross National Product at 1959 Factor Cost Prices (Rs. Mn.) ..	5,893	6,289	6,425	6,710	6,900	7,363	7,551	7,834	8,181	8,862
11. Gross National Product per Capita at 1959 Factor Cost Prices (Rs.) ..	612	635	632	643	648	675	676	685	699	741
B. Index Numbers 1959=100·0										
1. Gross National Product at Factor Cost Prices ..	100·0	106·7	107·1	110·3	115·3	123·7	127·0	130·6	139·5	166·4
2. Gross Domestic Expenditure at Market Prices ..	100·0	104·7	105·2	107·1	112·0	120·6	122·0	130·7	141·2	161·0
3. Private Consumption at Market Prices ..	100·0	108·3	106·0	108·1	115·2	124·1	126·9	135·3	144·8	162·9
4. Public Consumption at Market Prices ..	100·0	103·4	105·1	111·1	114·7	123·7	131·2	131·4	139·4	159·7
5. Gross Domestic Capital Formation at Market Prices ..	100·0	90·3	101·8	99·8	96·0	102·8	93·6	110·4	127·2	154·1
6. Exports of Goods and Non-Factor Services ..	100·0	99·7	94·6	97·8	94·4	96·1	103·9	92·5	91·7	107·4
7. Imports of Goods and Non-Factor Services ..	100·0	101·5	90·6	95·2	93·3	96·6	94·7	99·0	96·8	113·7
8. Gross National Product per Capita at Factor Cost Prices ..	100·0	103·8	101·4	101·7	104·3	109·2	109·5	109·9	114·8	133·9
9. Gross Domestic Expenditure per Capita ..	100·0	101·4	99·1	98·3	102·4	105·9	104·7	109·5	115·6	128·9

Source : Central Bank of Ceylon.

For explanatory notes see page 54.