1. ECONOMIC PERFORMANCE, PROBLEMS AND POLICIES—1969

Introduction

In 1969, the economy continued to expand at a satisfactory rate of growth, despite difficulties in the external sector. Growth in non-export agriculture, construction, manufacturing and services increased substantially and more than offset a decline in exports. The production capacity of the economy continued to expand through a high level of investment both in public and in the private sectors.

The Gross National Product at constant prices (i.e. in real terms) rose by 5.7 per cent, compared with a rate of growth of 8.3 per cent in the previous year. In absolute terms, there was in 1969 an increase in income by Rs. 509 million; the increases in 1968 and 1967 were Rs. 680 million and Rs. 363 million, respectively. In per capita real terms (i.e. after allowing for a population growth of 2.2 per cent in 1969) the rate of growth was 3.5 per cent as compared with 5.8[1] per cent in 1968.

The lower rate of growth in 1969 than in 1968 was the result of a decline in export income coupled with a slowing down of the very high rates of growth achieved in 1968 in most other sectors, as shown in the table below:

TABLE I - 1

Main Components of Economic Growth (At Constant Prices)

Rs. Million.

Items	1967	1968	1969
Increase in Gross National Product at Constant Prices over previous year	+ 363	+ 680	+ 509
of which:			
1. Total agriculture . ..	+ 219	+ 209	+ 73
(a) Exports	+ 11	+ 56	— 13
(b) Other agriculture	+ 208	+ 153	+ 86
2. Manufacturing	+ 44	+ 102	+ 67
3. Transport, storage & communications ..	— 10	+ 42	+ 99
4. Construction	+ 58	+ 95	+ 81
5. Others	+ 52	+ 232	+ 189

Non-export agricultural production continued to make a significant contribution to the increase in national product. Paddy production was [65.9 million bushels (940000 tons of rice) in 1969 compared to 64.6 million bushels in 1968. This was mainly due to the higher yields achieved both in the Maha and

1. Revised figure. The population estimates were revised recently by the Registrar General

Yala seasons. In the Maha season the yield increased from 47.5 bushels to 51.2 bushels per acre and was associated with a rise in net acreage harvested of 63,000 acres. In the Yala season there was a reduction in the net acreage harvested because of the drought conditions that prevailed but the yield per acre however rose from 44.6 bushels to 48.2 bushels.

The external payments situation caused concern throughout the year. Export income declined by Rs. 67 million, import payments increased by Rs. 297 million, the deficit in current invisibles rose by Rs. 61 million and capital payments increased by Rs. 124 million. The resource gap went up from Rs. 649 million in 1968 to Rs. 1,198 million in 1969. Excluding financing through aid and suppliers' credits of Rs. 583 million, the resource gap was Rs. 615 million. This had to be met by utilizing reserves and increasing short-term liabilities. The reserves, which were already at a low level, were drawn down by Rs. 86 million. The balance was financed largely by recourse to additional borrowing from foreign commercial banks (Rs. 227 million), I.M.F. drawings (Rs. 77 million), and increasing short-term credits (Rs. 185 million). A noteworthy feature in the financing picture was that, while in 1968 the net resources (i.e. drawings less repurchases) available from the International Monetary Fund totalled Rs. 165 million, in 1969 there was an actual repayment of Rs. 10 million. This change was in part responsible for the large-scale reliance on foreign commercial banks for financing the resource gap.

The domestic monetary situation was influenced substantially by the imbalance in the external sector. The decline in net external banking assets by Rs. 299.6 million was the major factor influencing the money supply. In the domestic field, while the private sector and co-operatives obtained Rs. 33.0 million of net resources from the banking system, Government drew Rs. 189.4 million and Government corporations a further Rs. 85.4 million. Thus, while the external sector was exerting a substantial contractionary effect on the money supply, the impact of the domestic sector-especially Government and Government corporations - was markedly expansionary. The net effect was a fall in money supply by Rs. 30 million on an end-year basis. The average level of money supply in 1969 was, however, higher than in 1968. A noteworthy feature was that fixed and savings deposits in commercial banks went up by Rs. 159.5 million, as compared with Rs. 125.4 million in 1968. The monetary situation was extremely tight in 1969. While the external sector exercised a substantial squeeze on commercial banks' resources, bank lending was also restrained by ceilings on credit expansion imposed by the Central Bank, in pursuance of a tight monetary policy, which was required to prevent the balance of payments situation from deteriorating further.

Prices moved up faster in 1969 than in 1968. The Consumers' Price Index rose by 7.4 per cent. in 1969 as against a rise of 5.9 per cent in 1968. There was also a noticeable increase in prices of goods and services not included in this index.

Wages were higher in 1969 than in 1968. There was a revision in salaries and wages in the Government sector in October 1969, while wages elsewhere in the economy were also higher than in 1968. While employment increased, registrants at employment exchanges too increased. Labour relations showed a marked improvement in 1969 until December when a number of strikes occurred.

As in the previous year, Gross Domestic Expenditure was in excess of available resources; the value of goods and services produced was able to sustain 93 per cent, of the total national expenditure. The deficit was financed by a larger volume of foreign assistance, increased indebtedness and drawing down external resources.

(A) Economic Performance

(a) National Product

The expansion of the economy in 1969 was stimulated by a high rate of investment both in the public and private sectors and an increase in goods and services for internal consumption.

Gross National Product at constant prices (real terms) according to provisional estimates rose by 5·7 per cent in 1969 compared with a rise of 8.3 per cent in 1968. At current factor cost prices, Gross National Product rose by 10.3 per cent from Rs. 9,809 million in 1968 to Rs. 10,821 million in 1969.

The commodity terms of trade moved against Ceylon by nearly 8 per cent. This resulted in an export loss or an impairment of import capacity by Rs. 811 million thereby causing real national product to fall by an equivalent amount.

Population in 1969 was estimated at 12.26 million people compared to 11.99 million in 1968. The average annual rate of growth in population was 2.2 per cent. Thus the increase in the real product after allowing for population growth was 3.5 per cent in 1969. Per capita real product rose from Rs. 739 in 1968 to Rs. 764 in 1969.

Private consumption expenditure at market prices rose by nearly 16 per cent over the level of the previous year. In this rise the import component of private consumption accounted for 24 per cent. When adjusted for price increases, the rise in private consumption was 12 per cent over 1968.

The increase in investment expenditure in 1969 was the highest on record. The rise in private sector investment was almost double that in the government sector. Capital formation in the private sector including public Corporations increased from Rs. 1,101 million in 1968 to Rs. 1,678 million in 1969 or by 52 per cent; government sector investment rose from Rs. 466 million to Rs. 564 million or by 21 per cent. The share of capital formation in gross national expenditure rose from 16.3 per cent to 19.1 per cent in 1969. Capital formation in transport showed a sharp rise of nearly 372 per cent while machinery and equipment accounted for a rise of 119 per cent. The import component in capital formation (at market prices) was 49 per cent and was higher than the ratio observed in the previous year.

Gross Domestic Expenditure exceeded Gross National Product at market prices by 7 per cent and was met by foreign assistance and drawing down of reserves.

(b) Fiscal and Monetary Developments

(2) Government Budget

According to provisional estimates, the total revenue collections in 1968/69 amounted to Rs. 2,497 million, and was Rs. 341 million or 15.8 per cent. more than that of the previous financial year. This was the biggest increase in revenue for any single year observed so far. The largest increase in revenue was from the sale of Foreign Exchange Entitlement Certificates, which accounted for Rs. 208 million or nearly two third of the increase. The importance of excise duties (especially turnover taxes) was further strengthened during this year as a result of larger turnover of manufactured goods and enhanced duty on tobacco, all of which accounted for Rs. 72 million of the increase. Though there was a fall of nearly Rs. 54 million in import duties there was an increase of Rs. 35 million in export duties mainly due to the satisfactory performance in rubber exports. It is also significant to note that revenue collections from corporate and personal taxes increased by Rs. 26 million, as a result of the higher incomes generated in the private sector and the satisfactory performance by the corporation sector in the previous year together with the adoption of improved methods to reduce tax evasion and avoidance. Over the past ten years revenue has been increasing at an annual average rate of 6.6 per cent. compared to a growth of 6.3 per cent in Gross National Product at current prices.

The provisional figures of total expenditure was Rs. 3,445 million in 1968/69; this was an increase of Rs. 438 million (or 14.6 per cent.) over the previous financial year. Of this increase Rs. 138 million or 32 per cent was in respect of capital votes. Capital expenditure in 1968/69 rose by 19.3 per cent while recurrent expenditure rose by 9.6 per cent. Bulk of the capital expenditure was for improving agriculture which is considered as the priority sector. Shifts in the pattern of public sector investment has been developing slowly as manufacture is becoming increasingly important. The proportion of under expenditure which declined in the previous year to 14.8 per cent dropped marginally to 14.3 per cent.

Transfer payments (gross food subsidy, interest payments on public debt, pensions, etc.) comprised 45.7 per cent of the total current expenditure. Gross food subsidy was Rs. 620 million and of this the producer and consumer subsidy on local rice amounted to Rs. 298 million. With higher market prices for local rice, the G.P.S. purchases were 13.7 million bushels in 1969 compared the previous year's level of 14.9 million bushels. The growth in current expenditure on social welfare programmes of education and health, was 8.4 per cent in 1968/69 compared to the growth in population of 2.2 per cent and growth in G.N.P. of 5 per cent. in 1969.

The budget provided for an overall net cash deficit of Rs. 701 million but the provisional figures indicate a net cash deficit of Rs. 788 million, or an increase of Rs. 87 million.

TABLE 1-2

Financing of Net Cash Deficit 1968/69
(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) ..	403·2	353·6	— 49·6
2. Local loans			
(a) Market borrowing from non-bank sources ..	286·5	202·5	— 84·0
(b) Non-market borrowing	—	52·2	+ 52·2
3. Total (1+2)	689·7	608·3	— 81·4
4. Net cash deficit	701·2	787·6	+ 86·4
5. Net expansionary financing (4-3)	11·5	179·3	167·8

A rise in net expenditure under capital votes by Rs. 110 million and in recurrent votes by Rs. 87 million resulted in a resource gap of Rs. 86 million. At the time the budget was prepared there was a fairly optimistic expectation of being able to contain the expansionary impact of fiscal operations to Rs. 12 million. As evident from Table I - 2 shortfalls occurred in main sources of non-expansionary borrowings resulting in expansionary impact of Rs. 179 million.

The sources of financing this net cash deficit is shown in Table I-3.

TABLE 1-3

Financing of the Net Cash Deficit 1964/65 to 1968/69

Rupees Million

Source	1964/65	1965/66	1966/67	1967/68	1968/69 Provisional
1. Total financing from non-bank sources ..	393·2	486·1	577·9	448·3	608·3
(a) Domestic non-market borrowing ..	50·3	112·2	72·3	9·8	52·2
(b) Domestic market borrowings from non-bank sources ..	243·2	255·9	297·0	248·3	202·5
(c) Foreign loans and grants ..	99·7	118·0	208·6	190·2	353·6
2. Domestic borrowing from the banking system ..	17·7	162·3	51·3	303·5	68·1
3. Use of Government cash balances and commodity aid counterpart funds—					
(a) Cash balances ..	19·5	-47·2	21·5	-48·4	62 9
(b) Foreign aid counterpart funds ..	—	-35·2	-43·9	12·3	48·3
4. Total net cash deficit ..	430·4	566·0	606·8	715·7	787·5
5. Adjustment for change in U.S. Aid Counterpart funds	-2·5	42·5	27·2	—	-0·3
6. Net expansionary impact of Government fiscal operations (2+3+5) ..	34·7	122·4	56·1	267·4	179·0

The use of counterpart funds and other cash balances of Rs. 111 million accounted for financing 14.1 per cent of the net cash deficit. Recourse to bank borrowing accounted for the balance. Central Bank advances and purchases of government securities and treasury bills amounted to Rs. 115 million. Commercial banks however reduced their holdings of government paper by Rs. 47 million. The treasury bill limit of Rs. 1,750 million was raised to Rs. 1,950 million, but the additional Rs. 200 million was not raised. The Central Bank continued to hold the bulk of the treasury bills (94 per cent. of the total issued).

Foreign assistance became the most important source of financing the deficit and was in the form of project loans (Rs. 47 million), non-project (commodity) loans (Rs. 287 million), and grants (Rs. 20 million).

The financing of the deficit was also heavily dependent on the institutional sources within Ceylon. Private savings channelled into financial institutions such as the Post Office Savings Bank, Ceylon Savings Bank, Insurance Corporation and the Employees Provident Fund are diverted to the financing of part of the Government's budget. These are now regarded more as an integral part of resources available rather than as a possible means of bridging the gap. The net contributions made by non-bank investor groups had been declining, thus creating a resource problem to the government. The Insurance Corporation of Ceylon and the savings institutions showed substantial reductions in their contributions to government paper in 1968/69. With the availability of better avenues of investments yielding higher rates of return and because of the traditional preference by the private sector for investment in assets that have a high rate of capital appreciation, investment in gilt-edged securities appear to have become relatively less attractive. Even though these institutions are generally considered to be 'captive sources' some of them are also looking for alternative forms of investment to enable them to give their customers better terms and conditions.

The excess of government payments over receipts has resulted more in an increase in cash holdings than in an increase in bank deposits as evidenced by the increase in the currency component of money supply. The banks raised their deposit rates in October, 1969 in order to make deposits relatively more attractive. Since the marketing of government securities is limited and since the banks themselves were faced with a resource problem they reduced their holdings of government securities by Rs. 47 million. in this financial year. The provision of additional finance by banks by purchasing government securities and treasury bills to enable government to meet the residual financing requirement reduces the liquidity of banks. The restraint on bank lending and the demands of the private sector for larger credit facilities make it more difficult to sell larger amounts of government paper to the private sector.

The net expansionary impact of government operations was less than that of the previous year. It was 7.2 per cent of total revenue in 1968/69 compared to 12.4 per cent in 1967/68.

In the budget for 1969/70, estimated revenue is Rs. 2,834 million and total expenditure is Rs. 3,793 million. The deficit expected to be financed from expansionary sources is Rs. 80 million.

(2) Money and Credit

The expansionary trend of the money supply of the earlier years slowed down in 1969. This is indicated both by the smaller growth (2.3 per cent) in the average monthly level of money supply in 1969 as compared to 1968 (6.9 per cent) as well as by the fall of Rs. 30.1 million, or 1.6 per cent, in end-year figures. The factors contributing to the decline in money supply as between end-December positions are depicted in the following table.

TABLE I-4

Changes in Money Supply
(End December 1968 to End December 1969)

Rs. Million

Factors Affecting Money Supply	Amount	
1. Expansionary factors:		
(a) Credit to Government from the banking system ..	117·5	
(b) Commercial bank credit to Government Corporations ..	69·9	
(c) Commercial bank credit to other private sector* ..	156·2	
(d) Decrease in other liabilities and accounts (net) of Central Bank	46·1	
(e) Decrease in Government cash balances ..	71·9	
(f) Adjustments	1·7	463·3
2. Contractionary factors:		
(a) Decrease in External banking assets (net) ..	299·6	
(b) Increase in time and savings deposits of Government Corporations	10·8	
(c) Increase in time and savings deposits of other private sector*	147·3	
(d) Increase in other liabilities and accounts (net) of commercial banks	35·7	493·4
3. Change in Money Supply		– 30·1

* Includes Co-operatives

The sharp fall of Rs. 299.6 million in net external banking assets in 1969 (compared to a fall of Rs. 116 million in 1968) was the major factor in the decline in the money supply in 1969. Among expansionary factors the increase of bank credit to the Government coupled with the utilisation of government's cash balances, on the one hand, and the expansion of credit to the private sector, on the other, were both important. The latter, however, was counter-balanced almost entirely by an increase in time and savings deposits of the private sector.

The rate of monetary expansion in 1969 was substantially lower than the rate of increase in Gross National Product. It is difficult to isolate the effect of monetary movements on the price level, especially over the short period of an year. However, in a growing economy like Ceylon, the volume of monetary expenditures should be expected to rise perhaps even faster than the increase in real national product. This increase in demand for the use of money appears to have been partly met by a rise in the velocity of circulation of money. Evidence of this development is provided by the increase in the turnover rate of demand deposits from 2.06 in 1968 to 2.26 in 1969. It should also be remembered that the increase in the price level in 1969 originated partly in an increase in costs.

Movements in credit by the banking system to the Government and the private sector are shown in the following table.

TABLE I - 5

Credit to Government and Private Sectors
(Annual changes in Rupees Million)

	1967	1968	1969
Government	+ 197·8	+ 192·0	+ 117·4
From Central Bank			
1· Loans and advances	+ 12·7	+ 37·5	− 7·6
2· Government securities	+ 109·9	+ 269·4	+ 112·0
Sub-total	+ 122·6	+ 306·9	+ 104·4
From Commercial Banks			
1· Import bills	+ 139·5	− 125·0	+ 87·9
2· Government securities	− 64·3	+ 10·1	− 83·1
3· Others	—	—	+ 8·2
Sub-total	+ 75·2	− 114·9	+ 13·0
Private Sector			
From Commercial Banks			
1· Government corporations	+ 11·4	+ 90·6	+ 69·9
2· Other Private sector (excluding export bills)	+ 94·2	+ 173·5	+ 156·2
3· Export bills	+ 1·0	+ 26·8	+ 5·7
Sub-total	+ 106·6	+ 290·9	+ 231·8
4· Adjusted for private sector securities held by the commercial banks	+ 1·8	—	+ 2·4
Sub-total	+ 104·8	+ 290·9	+ 229·3
Total Credit from Banking System	+ 302·6	+ 482·9	+ 346·7

Commercial bank credit to the private sector increased by Rs. 229.3 million in 1969 compared to the record expansion of Rs. 291 million in 1968. The smaller expansion in 1969 should largely be attributed to the operation of credit ceilings imposed by the Central Bank coupled with the lower liquidity of the commercial banks.

An improved pattern of bank lending to the private sector was also apparent in 1969. The most notable developments in this regard were the substantial growth in bank advances for industrial purposes and the decline in advances for import trading. The exclusion of medium and long-term loans for industry from the operation of credit ceilings and the provision of refinance facilities by the Central Bank for such loans no doubt contributed to the increasing importance of advances for industrial purposes in the assets portfolios of commercial banks, especially the Ceylonese banks. Credit for import trading appears to have been adversely affected, as intended, by the credit restrictions as well as as by the regulations governing the FEEC scheme. Advances for import trading declined by Rs. 16.8 million in 1969 in contrast to an increase of Rs. 75.5 million in 1968.

Refinance facilities were also available to banks in respect of medium and long term loans for agriculture. There was an increase in these loans from commercial banks to the agricultural sector. The special credit facilities provided as short term cultivation loans under the Agricultural Credit Scheme, however, were not being fully utilised. As the defaults increased, the total amounts granted as loans tended to decline over the seasons.

TABLE I-6

Percentage Rates of Growth in Deposits & Advances

	All Deposits	Loans & Advances
1967	9·0	34·3
1968	10·5	14·8
1969	6·0	25·4

It can be seen from the above table that in 1969 deposits with commercial banks increased by only 6 per cent, while loans and advances increased by 25.4 per cent. This slow growth in deposits, relative to the increase in advances, created a resource problem for the commercial banks in 1969. This tended to limit the resources available for lending to the private sector at a time when the Government itself required credit from commercial banks.

Commercial banks have engaged in the field of development finance by extending an increasing volume of medium and long term loans for industry and agriculture during the last two years. The extent of commercial bank participation in development finance, however, is bound to be limited in the long run. In fact, commercial banks' loans classified as medium and long term are largely for periods of 3–5 years. Longer term credit for industry has still largely to be obtained from specialised credit institutions whose resources are still limited. The Development Finance Corporation, the Agricultural and Industrial Credit Corporation and the State Mortgage Bank increased their lending in 1969.

(c) External Payments in 1969

The deficit in the current account of the balance of payments reached a record level of Rs. 808 million. The trade deficit alone accounted for Rs. 744 million. This large deficit in the balance of payments was the result of many factors. Among these were a further deterioration in the terms of trade due to a decline in the export price and a rise in import prices, and the maintenance of a high import demand relative to the rise in national product. In fact, the large balance of payments deficit was also a sign of higher economic activity and higher absorptive capacity of the economy. It might be mentioned that it was partly because the economy was growing that the deficit in the current account of the balance of payments continued to widen.

The value of merchandise exports declined by Rs. 67 million, while total export earnings from goods and services fell from Rs. 2,231 million in 1968 to Rs. 2,182 million in 1969 or by nearly 2 per cent. Imports of goods and services increased by 14 per cent. compared to a rise of 19 per cent in 1968. The current account deficit in 1969 was Rs. 808 million as compared with Rs. 383 million in 1968.

The percentage increase in imports was very much higher than the rise in national product; the import coefficient of private consumption rose to 0.24 in 1969 from 0.17 in 1968. Imports of investment goods rose by nearly 83 per cent. Maintenance imports, chiefly industrial raw materials and agricultural input increased substantially and contributed to an increase in industrial and agricultural output. But as incomes rise in rural areas, there is an increased demand for consumer durables such as radios and bicycles, which are assembled in Ceylon. Since these have a very high import content, the increased demand for consumer durables causes stress on the balance of payments situation.

The original foreign exchange budget for 1969 expected exports to finance at least Rs. 2,031 million of the import programme of Rs. 2,522 million. When it was clear that the export forecast could not be realised mainly because of the sharp fall in tea prices, substantial modifications were made in the import programme, either by deferring or by phasing out import orders. All imports of government departments were brought under licence control with effect from 15th June, 1969.

Under the original import programme for 1969, licences issued and letters of credit opened amounted to Rs. 2,765 million, compared to Rs. 2,786 million in 1968. Rs. 1,740 million was allocated for 'A' category imports and Rs. 650 million to 'B' category quota items. Letters of Credit opened for OGL imports amounted to Rs. 374 million and was Rs. 66 million more than that for the eight months (May to December) of 1968.

Import capacity fell sharply in 1969. In a situation of this nature where import capacity has been impaired, external assistance would be essential for the importation of intermediate and capital goods. Ceylon used Rs. 39 million more of its resources than in the previous year, but owing to a sharper fall in commodity exports, the resource gap generated in the merchandise account amounted to Rs. 163 million out of a total trade deficit of Rs. 744 million. Aid imports and suppliers' credits accounted for the balance Rs. 581 million. The invisibles account also showed a deficit of Rs. 64 million, thus increasing the gap in Ceylon's own resources to Rs. 227 million (and the total current account deficit to Rs. 808 million). The resource gap, taking into account, capital repayments and I.M.F. repurchases amounted to Rs. 1,198 million. The method of financing this resource gap is shown in the following table.

TABLE I - 7

Financing of the Deficit

Rs. Million

	1967	1968	1969
Merchandise			
1. Exports	1,650	1,976	1,909
2. Imports	1,985	2,356	2,653
3. Trade balance	− 335	− 380	− 744
4. Investment income	− 31	− 23	− 60
5. Interest payments	− 22	− 30	− 44
6. I. M. F. repurchases	− 18	− 48	− 87
7. Capital amortisation or repatriation ..	− 60	− 218	− 303
8. Other current account transactions ..	+ 53	+ 50	+ 40
Total (3 to 8)	— 413	— 649	—1,198
Financed by:			
Commodity Aid	178	255	272
Project Aid	34	40	89
Suppliers Credits..	n.a.	n.a.	176
I. M. F. purchases	123	213	77
Bank borrowings	57	—	227
Short term credits	7	84	185
Bilateral balances	80	42	18
External assets	− 131	− 14	86
Grants	46	28	46
Private Capital	9	8	9
Other	10	− 7	13
Total	413	649	1,198

Unlike in the previous year when the International Monetary Fund was the principal source of supply of short term funds there was a shift in the composition of the methods of financing. The I. M. F. provided 6.4 per cent of the total resource gap. In fact, net drawings from the International Monetary Fund, i. e., drawing less repurchases resulted in a repayment of Rs. 10 million. Commodity aid loans at Rs. 272 million comprised the biggest source of financing which was 22.7 per cent of the total resource gap. There was a substantial increase in project aid from Rs. 40 million in 1968 to Rs. 89 million in 1969. Suppliers' credits accounted for Rs. 176 million or 14.7 per cent of the total amount while short term credit increased from Rs. 84 million in 1968 to Rs. 185 million in 1969; foreign borrowings amounted to Rs. 227 million or 18.9 per cent of the total gap. There was a decrease in the total external assets by Rs. 86 million and the international reserve of the Central Bank declined by Rs. 70.3 million, while commercial bank balances declined by Rs. 18.9 million. Assets of Government and Government Agencies increased from Rs. 70.2 million to Rs. 73.5 million.

The Central Bank obtained a large volume of short term credit from abroad. Since there was tightness in the foreign capital markets in the background of world wide inflation, high levels of interest prevailed all over the world. In the wake of falling export incomes and rising imports it was necessary to borrow from abroad even at these high rates. However, given a persistent resource gap it is preferable to finance it through long term aid, both project and commodity aid, rather than placing reliance on short term foreign credit because the latter tends to aggravate the balance of payments situation by imposing a heavy debt servicing burden in the short run.

(d) Prices

The factors that affected the movement of domestic prices in 1968 persisted in a more intensified form in 1969. Inflation was a world wide phenomenon. Practically all the advanced countries exhibited larger variations in prices in 1968 and 1969 much above the long term average. Ceylon had to pay higher prices for her imports; these external prices had an important influence on the domestic price level and real incomes.

The Colombo Consumers' Price Index rose by 7.4 per cent in 1969 compared to a rise of 5.9 per cent in 1968. Due to the large weightage given to subsidised and price controlled items and the general unrepresentative nature of the index because of the out-of date weights base, the overall index may not be very sensitive to the actual changes in prices.

In the manufacturing sector the prices of industrial goods rose at a declining rate. The greater availability of industrial goods through larger domestic supplies and imports kept the magnitude of the price rise to a lower level. There was also an appreciable increase in locally produced agricultural products.

During periods of rising prices there are certain types of goods and services whose price structure tends to lag behind and keep out of alignment with the general price level. In this, the price policies followed by the government enterprises are most significant. The pricing policies adopted by some government enterprises are unrealistic in relation to costs and the general level of prices. Such distortions of prices within the domestic economy tend to create budgetary problems and the impact of stabilisation policies may not be fully felt.

(B) POLICIES AND MEASURES

(a) The Balance of Payments Constraint

Among the several measures of economic growth, the simple norm of national income performance is widely used. A rise in Gross Domestic Product accompanied by a rise in per capita income and a reduction in the inequality in the distribution of that per capita income are important considerations in judging performance of a developing country such as Ceylon. The resources of the country have to be mobilised for the development of the economy so that living standards may be raised at a sufficient rate. One of the biggest constraints in this process is the foreign exchange shortage.

Recurring balance of payments deficits on current account resulting in severe shortages of foreign exchange acted as a break on the development of certain growth sectors of the economy. In the meantime, import requirements increased, not only to cope with a higher import demand due to population growth, but also to meet the essential capital requirements for industrial and agricultural growth.

Ceylon's capacity to import from its own resources had been declining as a result of a variety of causes. One of the most significant of these is the decline in export incomes as can be seen from table 1-8.

TABLE 1 – 8

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 ..	1,777	– 11	2	– 44	1,724	1,939
1964 ..	2,060	– 316	2	– 34	1,712	1,870
1966 ..	1,928	– 505	– 12	– 36	1,375	1,740
1967 ..	2,002	– 667	– 2	– 45	1,288	1,442
1968 ..	2,022	– 784	– 3	– 29	1,206	1,430
1969 ..	1,951	– 811	– 3	– 58	1,079	1,577

In export performance, the country has been particularly unfortunate, in that whereas world exports rose by 11.5 per cent in 1969, Ceylon's own exports fell by 3 per cent, mainly because of changed demand conditions in world trade for the type of commodities produced by Ceylon.

Over-supply of such commodities as tea and declining consumption by major consuming countries due to competition from substitutes, resulted in a sharp fall in prices, and this trend is likely to continue as long as supply is in excess of demand.

At the same time there was a marked increase in import prices due to the inflationary situation abroad, largely caused by speculative tendencies in the world money markets and higher consumption demand for industrial goods. A further factor was the increase in freight rates.

It is to be noted that the servicing of Ceylon's external debt is absorbing an increasingly large proportion of total export earnings. At the end of December 1969, external debt was Rs. 1,718 million. Debt servicing, which includes interest and capital repayments was nearly 14 per cent of total export earnings in 1969. This debt servicing in its present form is a short term one as the repayments of capital and interest are largely on account of short term debts such as I. M. F. drawings and suppliers' credits and short term credit.

There has been, in recent years, a shift in the sources of external funds for financing the 'resource gap' with greater recourse to suppliers' credits and short term borrowings from banks abroad. In the present foreign exchange situation there would appear to be a need for larger doses of foreign aid on softer terms, if Ceylon's import capacity is to be raised so that a growth rate consistent with a rise in living standards may be maintained. Increased credit stringency in the financial markets abroad has reduced the scope for short term borrowing abroad and raised interest charges considerably with resultant heavier debt service charges.

The scope for substantial cuts in import expenditure is severely limited. In 1969, nearly 45 per cent of Ceylon's imports constituted consumption goods. About 23 per cent of imports were intermediate goods which are required to maintain the industrial and agricultural development programmes, while about another 28 per cent were required for development projects. These development projects may be tied to some aid programmes and would not be a drain on our own resources. Thus any curtailment of import demand will have to be applied to consumer goods. Appreciable reductions in imports of consumer goods would result in a fall in the standard of living and a rise in prices, till such time as the domestic sector can increase production adequately. There was, in fact, a decline in the consumption demand for imports. Also, adjustment being made for population increase, imports of consumer goods in per capita terms decreased from Rs. 125 in 1959 to Rs. 96 in 1969. At constant prices, the decrease was even more-from Rs. 124 to Rs. 60. The following table shows the trend of imports in per capita terms.

TABLE I-9

Total Imports (Customs Data) Adjusted for Food Commissioner's Imports of Rice, Flour and Sugar

Year	Adjusted Data at Current Values				Adjusted Data at Deflated Values (1958=100)			
	Consumer Goods		Total Imports		Consumer Goods		Total Imports	
	Value (Rs. Mn.)	Per Capita Imports (Rs.)	Value (Rs. Mn.)	Per Capita Imports (Rs.)	Value (Rs. Mn.)	Per Capita Imports (Rs.)	Value (Rs. Mn.)	Per Capita Imports (Rs.)
1959	1,203	125	2,005	208	1,191	124	1,966	204
1960	1,195	121	1,960	198	1,183	120	1,903	192
1961	972	96	1,703	167	972	96	1,686	166
1962	979	94	1,733	166	999	96	1,824	175
1963	919	86	1,628	153	828	78	1,550	146
1964	1,172	107	1,884	173	1,010	93	1,761	162
1965	1,028	92	1,723	154	935	84	1,581	142
1966	1,040	91	1,907	167	937	82	1,603	140
1967	966	83	1,773	151	847	73	1,441	123
1968	1,113	93	2,139	178	718	60	1,337	111
1969	1,174	96	2,499	196	734	60	1,515	119

The import trends in per capita terms, as shown in the above table, have been influenced not only by changes in per capita income but also by government policies in respect of agricultural expansion and import substitution.

The policy of import substitution has been followed both in agriculture and in industry. Developments in recent years have demonstrated the high potentiality for import substitution in agriculture. Substantial savings of foreign exchange have been achieved, especially in food imports. Thus, in 1969, (according to the Food Commissioner's data), there was a gross import saving of Rs. 134 million, as a result of a reduction in import volume by 84,000 tons. When allowance is made for imported inputs, the import savings amounted to at least Rs. 86 million.

The benefits to Ceylon of import substitution in industry are, however, rather mixed. Expansion in manufacturing industry, which became one of the dynamic sectors of the economy in the early sixties, was to an appreciable extent impeded in mid-sixties, mainly as a result of foreign exchange difficulties. The exchange reforms of May 1968 and the accompanying import liberalization enabled industry to utilize existing capacity to the fullest extent possible and also to increase capacity considerably on the basis of imports of raw materials and capital equipment. However, although in physical terms there was a noteworthy increase in production, it cannot be said that the growth in industry was entirely in the right direction.

This industrial activity developed under the shelter of virtual ban on imports of competing products, leading to the growth of uneconomic industries operating largely under near monopoly conditions. The prices of manufactured goods continued to be very high, whereas the quality standards of a great many of them were quite low.

Import substitution in industry with large-scale reliance on imported raw materials has constituted a heavy burden on foreign exchange. It was noted eleswhere that maintenance imports accounted for nearly 23 per cent of total imports, the bulk of which is used as raw material and other essential inputs for industry. In absolute terms, this worked out to about Rs. 300 million in 1969, apart from remittance of profits, dividends, royalties and technical service fees. Because of the poor quality, low durability and high import content of several locally produced goods, the actual expenditure of foreign exchange in some cases was very much in excess of the value of imports of the finished products required to meet the market demand. Complete protection would not lead to the growth of efficiency and the realization of economies of scale through specialization. Exposure of domestic industries to some competition through imports or in competitive foreign markets would help in the creation of a viable industrial sector.

In view of the limited size of the internal market, growth of domestic industry would largely depend on the scope for expansion of industrial exports. The following table compares the growth in industrial production with that of the growth of industrial exports.

TABLE I 10
Industrial Growth

	1960	1963	1966	1967	1968	1969
Industrial Production (at constant prices) ..	728	853	1008	1052	1154	1221
Growth rate over previous year ..	—	7·1	7·6	9·7	7·7	5 8
Industrial Exports Rs. Million (Constant prices) ..	73	73	67	77	83	82
Per cent of Domestic exports at constant prices ..	4·1	3·8	3·5	3·9	4·0	4·2
Employment Index ..	100	131	284	364	506	518

Source: Central Bank of Ceylon.

Export volumes of industrial products which had shown a downward trend till 1966 registered a significant acceleration as from 1967, aided by the stimulus provided by the rupee devaluation, the bonus voucher scheme and the premium receivable under the FEEC scheme.

The growth of manufacturing industry in Ceylon has brought in many advantages, and also some disadvantages. The "assembly type" of industries required only small conversion of inputs; some of these are capital intensive. Though this type of growth may have been successful in terms of physical output, growth of technical competence and provision of employment, it may have resulted in a misallocation of resources, especially because of the existence of a captive market internally.

(*b*) *Monetary Policy*

Monetary policy in 1969 continued to be dominated by the exigencies of the balance of payments situation. The Annual Report for 1968 emphasised the need for Policies directed towards the containing of the progessively worsening balance of payments. Monetary policy in this respect was aimed at dampening the growth in monetary demand which had been occurring cumulatively over the past years as a result of large increases in the money supply caused mainly by expansionary budget deficits; these in turn tended to exert pressures on the country's external reserves.

The FEEC Scheme itself contained vital monetary aspects which had the same objectives. The series of measures taken in the field of monetary policy in 1968 were complementary to the policies adopted in regard to the foreign exchange budget and the fiscal budget. All these policies were in fact integral parts of the general economic policy implied in the FEEC Scheme.

Viewed in this perspective, monetary policy had to be restrictive. In order to mitigate the severity of the effects of a restrictive monetary policy on economic growth and on exports it was desirable to permit a limited extent of credit expansion; differing shares of this expansion were to be allocated to different sectors on an order of priorities. Thus, the high reserve ratios continued to be effective and ceilings were maintained both on the domestic assets of the Central Bank and on commercial bank credit to the private sector with a view to restraining the increase in money supply and in total domestic credit in particular. A selective approach was adopted in the matter of credit ceilings. The Central Bank also continued to make refinance facilities available to growth sectors.

The credit restraints which had been introduced in 1968 and which were in force at the beginning of 1969 are described elsewhere in this Report. Credit to government corporations was initially exempted from the ceilings imposed on commercial bank credit so as not to place undue restrictions on their activities. These corporations, which had earlier obtained their finance from the government were, from October 1968, required to obtain credit for their requirements of working capital from the commercial banks. Even allowing for this transitional period, it was observed that that commercial bank credit to corporations increased at a fairly rapid rate. Inventory building by many corporations had been going on while at the same time they were maintaining production at the same or higher levels. Clearly these corporations were insensitive to such factors as interest rates as they were building up large stocks of raw materials and finished goods. The Central Bank kept a close watch on this increase in credit and in June 1969 imposed a ceiling on it. In order, however, to avoid a disruption in their activities, the ceiling on this credit was worked out on a relatively liberal basis. The imposition of the ceiling did, however, have the effect of slowing down the expansion of credit to this sector.

Thus, the coverage of credit restrictions was enlarged in 1969 by the inclusion of government corporations, and the percentage increase allowed in the items covered by the ceilings from June 1969 was about the same as for the previous seven months. The new ceilings, however, permitted a greater increase in absolute amount since they were calculated on a larger base.

The attainment of the broader objective of restraining the growth of monetary demand was hampered by the outturn of the government's fiscal operations. While the government bugeted for an expansionary financing of Rs. 12 million in the financial year 1968/69, the actual figure turned out to be Rs. 179 million. In the calendar year 1969, the expansionary effect of the government's fiscal operations (as reflected by banking statistics) was Rs. 236 million. Thus, while the budget was expected initially to produce a neutral effect on the money supply, it caused a substantial expansionary effect.

The foreign exchange budget did not anticipate a large fall in reserves or a large increase in short-term bank borrowing abroad. By the middle of the year, however, it was clear that further measures were needed to contain the widening of the balance of payments deficit. Accordingly, the FEEC rate was increased from Rs. 44/- to Rs. 55/- per Rs. 100. The need for curtailing monetary demand for imports by the imposition of letter of credit margins was examined. It was found necessary to adopt this measure only on a limited scale.

The inability to stem the upsurge of demand for imports may be traced- to the extent that monetary causes can be attributed to it- largely to the increase in the expansionary financing of the government's deficit. It is true that the underlying forces of an increase in monetary demand cannot be apportioned as originating in the expansionary finance of the government's fiscal operations and in the increase in credit to the private sector. However, in analysing the actual operation of policies which were aimed at achieving the same objective it is clear that while the increase in credit to the private sector could be kept within the limits planned at the beginning of the period, the expansionary gap of the government's operations could not be managed with equal success.

It is pertinent to add that the reversal of the trend of monetary expansion which has been persistent for over a decade cannot be achieved in the short period of an year. It must, however, be noted that policies adopted towards this end met with obstacles in the field of fiscal management and foreign exchange budgeting. These obstacles, only some of which were unforeseen, have been discussed elsewhere in this Report.

The Central Bank sought to control the expansionary effects of government's fiscal operations and of bank credit to the private sector by observing ceilings both on its own net domestic assets and on commercial bank credit to the private sector. Although the achievement of these measures consisted only of a restraint on expansion of credit to the private sector, an aspect of banks' credit operations in this sector which may be of concern in the future should be mentioned here. The slower growth in deposits with banks relative to the growth in advances was referred to earlier. A disparate growth of this nature tends to increase the reliance of commercial banks on resources created by the Central Bank. The Central Bank, however, has to be conscious of the inflationary consequences of such a creation of primary credit which is reflected as an increase in its domestic assets. These inflationary pressures can be relieved if banks accelerate the accumulation of deposits of the public to keep pace with the increase in demand for advances. As the latter is bound to increase rapidly with the increase in activity, the need for greater efforts by banks towards a faster rate of deposit mobilisation becomes crucial to the problem of economic growth with monetary stability.

Apart from the retardation of the overall growth in advances, the credit policies of the Central Bank, especially in their selective aspects, helped the welcome evolution of an improved pattern of commercial bank lending to the private sector. As discussed elsewhere, the relative weight of advances to the industrial sector increased during the year, while that of advances for import trading declined. In the term structure of advances, too, an increase in medium and long term advances for industry and agriculture was evident in 1969.

The behaviour of cultivation advances to the agricultural sector was, however, disappointing. Over the period of a little more than two years of the operation of the new Agricultural Credit Scheme defaults increased; the gross amounts granted and the coverage of the scheme declined. The experience of 1969 clearly points to the need for an urgent appraisal of the scheme with a view to refashioning it as an effective instrument of growth in this vital sector of the economy.

There are several financial institutions that operate outside the banking system. These financial intermediaries have offered attractive interest rates on deposits thus attracting some of the savings of the community.

The size of these financial intermediaries and the volume of business transacted by them have not been unduly high. So long as they hold a part of the financial assets of the public, credit control policies may not be effective to that extent. Since they compete for the savings of the community with the banks and the government by acting on the margin, they can have a large influence in determining market trends and interest rates.

Restrictions on credit were also intended to induce enterprises to use their own resources. Ploughing back profits by foreign companies operating in Ceylon would, among other things, depend on the return to such investments. If the interest rate abroad is more attractive than the domestic rate, these companies would prefer to remit their profits abroad for investment. The Bank Rate remained at 5½ per cent per annum throughout the year, while the treasury bill rate increased from 3·64 to 4·10 per cent. Commercial banks put up their deposit rates by a half to three quarters of a percentage point.

When credit restrictions are in operation the velocity of money will tend to rise. As long as cost of borrowing is below the percentage increase in prices (i. e. negative rate of interest) credit restrictions work more effectively by restricting the availability of credit rather than raising its cost. It was, however, clear that interest rates in Ceylon in the organised money market were unrealisti·. Interest rates levels in major financial centres of the world rose. Banks put up their deposits rates in October of the year. By the end of the year an across the board increase in interest rates was under consideration.*

CONCLUSION

The economy continued to expand at a satisfactory rate of growth of 5·7 per cent in 1969. This was more than the population growth of 2·2 per cent. Thus the per capita real income rose by 3·5 per cent.

The expansionary impact of government operations was less than in 1968. The monetary policies adopted in 1968 were continued in 1969 and the rate of expansion of credit to both the private and public sector showed a decline. Prices continued their upward movement and rose by 7·4 per cent over the year.

The recurrent deficit in the balance of payments resulted in a very large resource gap. This was financed by foreign assistance and drawing down of reserves. Debt servicing charges were high mainly due to the high weightage of short-term debt servicing in total foreign debt Despite unfavourable external factors, production for domestic use showed a significant increase. There was an increase of industrial production by 16 per cent, construction activity by 29 per cent and non-export agriculture by 7 per cent. The most notable feature was a high level of investment activity both in the private and public sectors resulting in an appreciable increase in production capacity.

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* The Bank Rate was raised to 6½ per cent on 11th January, 1970