I. ECONOMIC PERFORMANCE, PROBLEMS AND POLICIES – 1972

1. INTRODUCTION

In 1972, according to provisional estimates, Sri Lanka's economic growth, as measured by the Gross National Product at constant prices, increased by 2.5 per cent compared to a rate of growth of 0.9 per cent in the previous year. When allowance is made for the population increase of 2.1 per cent in 1972 the increase in real product per person was only 0.4 per cent. The increase in total real product was largely due to an expansion in output of goods for domestic use, specially livestock products, fish, subsidiary food crops and coconut. This increase offset the fall in output of tea, paddy and rubber. Income generated by the manufacturing sector rose by only 1.6 per cent in real terms because its output growth was adversely affected by the shortage of raw materials arising from the foreign exchange constraint. Construction activity declined mainly as a result of a shortage of building materials.

The increase in money supply was wholly confined to the last quarter of the year. As mentioned elsewhere this was entirely due to fortuitous circumstances arising from the banks strike. It is, therefore, more meaningful to assess the performance of the monetary sector by confining the analysis to the period immediately prior to the strike. During this period money supply rose only by 0.3 per cent over the corresponding period of the previous year.

Prices moved up faster than in 1971. Shortages of domestically produced and imported goods would have raised prices even further, but for the continuation and extension of price control. Monetary expansion in the last quarter of 1972, together with an increase in the velocity of turnover and higher income velocity, would have resulted in the price level going up faster during that part of the year.

Government revenue increased by 17 per cent while government expenditure rose by 12 per cent over the previous year. The increase in revenue came mainly from Foreign Exchange Entitlement Certificates, surplus of government monopolies, excise duties and from trading enterprises. Increases in expenditure were mainly due to a rise in current expenditure by 16 per cent and capital expenditure by 8 per cent.

The balance of payments on current account continued to remain adverse and became more unfavourable than in the previous year. Despite stringent controls, import surplus was larger than in 1971, and was mainly caused by the higher prices of imports. Currency realignments also caused prices to move up whilst at the same time pushing up Sri Lanka's debt servicing burden.

Aggregate expenditure on consumption and capital formation continued to be in excess of the value of goods and services produced domestically by nearly 1.3 per cent. This deficit had to be met by foreign assistance and short term credits.

2. ECONOMIC PERFORMANCE

(a) Gross National Product

As already mentioned, Gross National Product at constant prices rose by 2.5 per cent during the year. Though the rate of growth shows an improvement over the previous year, it is well below the average rate of 4.3 per cent attained during the last decade. In money terms (at current factor cost prices) Gross National Product rose by 7.1 per cent to Rs. 12,662 million from its value of Rs. 11,828 million in 1971. With an estimated population of 13 million, or an increase of 2.1 per cent in 1972, real product per capita increased by only 0.4 per cent from Rs. 766 to Rs. 769.

The downward movement of the commodity terms of trade continued and recorded a decline of 3.7 per cent. This decline in the capacity to import (or loss in purchasing power of exports) was mainly caused by high import prices due to currency realignments combined with inflationary pressures abroad. Consequently, capacity to import declined in terms of 1959 prices by Rs. 970 million as compared with Rs. 955 million in 1971.

The increasing trend in private consumption expenditure interrupted in 1971, resumed with the expenditure going up by 10.4 per cent. Breakdown of private consumption expenditure shows that expenditure on imported goods and services has increased by 16.4 per cent, while expenditure on locally produced goods and services has gone up by 9.2 per cent. Public consumption rose by 7.5 per cent as compared to 8.6 per cent in 1971. The import content of private consumption expenditure, in money terms, being 10 per cent, was similar to that in 1971.

Total fixed capital formation increased by 3.1 per cent as against a decline of 12.4 per cent in the previous year. Stocks, on the other hand, declined sharply and the end result was that capital formation declined by 11.3 per cent.

(b) Fiscal and Monetary Developments in 1972

(i) The Government Budget 1971/72.

The Budget for 1971/72 was drawn up for a period of 15 months from 1st October, 1971 to 31st December, 1972 in view of the decision to adopt the calendar year as the fiscal year from 1973. The Approved Estimates for 1971/72 expected a total revenue of Rs. 3,945 million. Provisional data reveal that the actual performance has in fact been higher; the total revenue collections amounted to Rs. 4,102 million. Reduced to a pro-rata 12 - month basis this represents an increase of Rs. 403 million over the revenue collections of 1970/71. The significant increases in revenue were in respect of sale of FEECs, profits from the sale of arrack, Business Turnover Tax and tobacco tax. The large volume of deferred payments, particularly those made by the Food Commissioner in respect of sugar imports effected earlier, helped to increase FEECs revenue by Rs. 140 million. The profit from the sale of arrack was mainly accounted for by the substantial increase in the volume of sales, while the increase in the rate of tobacco tax contributed to an increase in revenue from this source.

There have, however, been decreases in revenue in respect of profits from food sales, export duties and import duties. The profit from food sales, which in 1971/72 was essentially derived from the sale of sugar, has exhibited a gradually declining trend over the years. The levy of FEECs on sugar imports, together with their higher import prices, had reduced the profits from this source. For the first time the Government had also incurred a subsidy on the sale of flour. The depressed prices for coconut products led to a decrease in the collection of export duties while the programmed reduction of imports has led to a fall in the collection of import duties. The relative weight of customs duties in total revenue continued to decline and stood at 15 per cent in 1971/72.

Revenue from turnover tax and excise duties once again registered a significant increase of Rs. 69 million and Rs. 79 million respectively. They have now become buoyant sources of revenue to the Government. In contrast, direct tax revenues have remained virtually stagnant over the last two years, and are in fact estimated to decrease in the current financial year 1973.

The Approved Estimates for 1971/72 provided for a total expenditure of Rs. 5,743 million. In addition, there were supplementary estimates amounting to Rs. 146 million in respect of recurrent expenditure and Rs. 79 million in respect of capital expenditure, during the course of the financial year. Actual expenditure for 1971/72 amounted to Rs. 5,809 million – an increase of 1.0 per cent over the original estimates. On a pro-rata basis the increase over 1970/71 was, however, 10.5 per cent. The proportion of recurrent expenditure in total expenditure at 72 per cent remained at the same level as in 1970/71.

Notwithstanding the provision of supplementary estimates, capital expenditure in 1971/72 has been less than originally estimated. The pro-rata increase over the previous financial year was Rs. 67 million or 8 per cent.

The net expansionary impact of government fiscal operations is summarised in the following table.

TABLE I – 1

Financing of the Deficit 1969/70 to 1971/72

Rs. Million

	1969/70	1970/71	1971/72 Provisional	
			12 months*	15 months
1. Budget Deficit	1,150	1,327	1,366	1,707
2. Less: Sinking Fund contributions, etc. ..	214	244	330	412
3. Net Cash Deficit	936	1,083	1,036	1,295
4. Financing				
(i) Total financing from non-bank sources ..	511	866	925	1,156
(a) Domestic non-market borrowing ..	16	140	199	249
(b) Domestic market borrowing from non-bank sources ..	269	492	441	552
(c) Foreign loans and grants ..	226	234	284	355
(ii) Domestic borrowing from the banking system	451	94	226	283
(iii) Use of Government cash balances and Foregin Aid Counterpart Funds ..	– 26	123	– 115	– 144
(a) Cash balances	– 31	– 3	– 88	– 110
(b) Foreign Aid Counterpart Funds ..	5	126(a)	– 27	– 34
5. Adjustment for change in U.S. Aid Counterpart Funds	...	1	—	—
6. Net expansionary impact of Government fiscal operations (4 ii, 4 iii & 5)	425	218	111	139

(a) The Central Bank Foreign Aid Counterpart Fund as at the end of September, 1971 was overdrawn by Rs. 112·8 million. This overdrawn position is the result of the delay in recording of Commodity Aid receipts. Also, please see footnote on page 155 of Annual Report 1971.

* on a pro-rata basis.

The net expansionary impact of the budgetary operations during 1971/72 amounted to Rs. 139 million. The strike of the employees of commercial banks interrupted the flow of revenue receipts to the government with the result that towards the end of the financial year the government was compelled to raise Rs. 300 million by way of Treasury Bills. The cash balances, however, stood at Rs. 144 million. This unusually high balance at the end of the financial year is to be explained partly by the fortuitous circumstances consequent to the banks strike.

Although the Government was confronted with an enlarged unbridged gap of Rs. 446 million (mostly as a result of the withdrawal of certain measures proposed in the Budget 1971/72), recourse to the banking system on a major scale has been avoided. It should, however, be noted that the net cash deficit for 1971/72 was considerably reduced partly as a result of the shortfall in capital expenditure. An equally important aspect is the inability of the Government to contain its rate of increase in recurrent expenditure and generate adequate surpluses on its current account.

The food subsidy bill has risen rapidly in the past few years. Although successful and determined efforts have been made to mobilise additional domestic resources, the absence of a more positive approach towards curtailing current expenditure, particularly transfer expenditure, resulted in revenue gains being merely frittered away in non-development expenditures. The increase in capital outlays in 1971/72 has been very small. As long as transfer payments make a heavy claim on available resources, the realisation of development aims will be thwarted by having less money to finance the development efforts. The past Annual Reports have drawn attention of the Government to its inability to generate adequate current account surpluses to finance the larger portion of development expenditure. As long as the scale of such outlays on transfers are not kept within limits aims of development will be frustrated.

Reliance on foreign finance for purposes of bridging the Budget deficits had appeared to decline during the last two financial years. Although its contribution towards financing the deficit has once again increased to 35 per cent of the Budget deficit in 1971/72, receipts of foreign finance have constantly fallen short of originally estimated receipts in recent years. On the other hand, market borrowings from non-bank sources have come to contribute substantially towards financing the deficits in the last three years. Correspondingly, the servicing of debt has also begun to raise problems of finding resources to meet the interest payments. Interest payments have increased at 20 per cent per annum (compound) during the last five years, which is nearly double the rate of increase in the previous five years.

The Budget for 1973 provides for total expenditure of Rs. 5,161 million and expects the total revenue to amount to Rs. 3,880 million. The resultant Budget deficit would thus amount to Rs. 1,281 million. This deficit is to be financed through domestic non-bank borrowings of Rs. 600 million, foreign finance of Rs. 541 million and administrative borrowings of Rs. 50 million. leaving a gap requiring bank finance amounting to Rs 90 million.

(ii) Money and Credit

The sharp increase in money supply in 1972 was caused mainly by factors resulting from the commercial banks strike which commenced on 1st September and ended on 17th December, 1972. The end-December figures indicate an increase in money supply of Rs. 329.4 million or by 15.3 per cent, compared to an increase of Rs. 182.5 million or 9.3 per cent in 1971. However, the increase in the money supply between end-December 1971 and end-August 1972, the period, immediately preceding the banks strike, was only 0.3 per cent (Rs. 6.0 million).

When data on money supply for the entire year 1972 are considered, a major factor contributing to its increase was the issue of Treasury Bills amounting to Rs. 300 million in November and December 1972. This amount was almost entirely contributed by the banks. The Government had to issue Treasury Bills to tide over the temporary cash shortage which arose principally from the fact that cheques received by various government departments, amounting to about Rs. 153 million, were not credited to government accounts because of the strike. Bank credit to the private sector (net of time and savings deposits) too, showed a very large increase of Rs.219.5 million, mainly due to the relatively free use of overdraft facilities necessitated by the strike. While it is impossible to quantify the precise effects of the banks strike on monetary expansion, the facts discussed tend to show that the real increase in money supply would have been markedly lower than the rate of 15.3 per cent shown by the available statistics.

The disruption in banking activities caused by the strike has been such as to render a review of monetary and banking developments, using data for the year as a whole, meaningless. The following paragraphs, therefore, deal with the salient features of the monetary and banking field in the period January–August, 1972.

This eight-month period was characterised by a mild monetary expansion of 0.3 per cent. The monthly average level of money supply was, however, 2.4 per cent higher than in the corresponding period of 1971, though the average for the 1971 period was 6.5 per cent higher than that of the corresponding period in 1970. This was accompanied by a 9.0 per cent increase in the monthly average rate of turnover of demand deposits held by the public.

The main factors responsible for the change in money supply are depicted in the following table.

TABLE I - 2

Factors Affecting Money Supply (1969 - August, 1972)

Rupees Million

	1969	1970	1971	Dec '70 Aug '71	Dec '71 Aug '72
External Banking Assets (Net) ..	- 299·6	- 1·5	+ 200·5	+ 290·0	+ 43·4
Domestic Credit ..	+ 343·5	+ 497·3	+ 233·6	+ 22·2	+ 95·1
1. Government ..	+ 117·5	+ 349·8	+ 90·6	+ 2·3	- 35·4
2. Private Sector ..	+ 226·0	+ 147·5	+ 143·0	+ 19·9	+ 130·5
(a) Government Corporations ..	+ 69·9	+ 43·2	+ 62·3	+ 31·3	+ 6·0
(b) Other ..	+ 156·1	+ 104·3	+ 80·7	- 11·4	+ 124·5
Government Cash Balances ..	+ 71·9	- 124·2	+ 67·4	+ 66·1	- 29·4
Time and Savings Deposits of the private sector ..	- 158·1	- 178·8	- 137·7	- 69·9	- 33·7
(a) Government Corporations ..	- 10·8	+ 17·5	+ 6·2	- 7·9	- 2·5
(b) Other ..	- 147·3	- 196·3	- 143·9	- 62·0	- 31·2
Other Items (Net) ..	+ 12·1	- 109·1	- 181·3	- 132·4	- 69·4
Money Supply, of which: ..	- 30·1	+ 83·5	+ 182·5	+ 176·0	+ 6·0
Currency .	+ 17·7	- 148·8	+ 180·2	+ 187·0	+ 42·1
Demand Deposits ..	- 47·8	+ 232·3	+ 2·3	- 11·0	- 36·1

Signs denote effect on Money Supply

A noteworthy feature was the decline of Rs. 35.4 million in bank credit to the Government and an increase of Rs. 29.4 million in government cash balances. These figures are not, of course, comparable with those of the corresponding period in 1971, because of the change in the Government financial year; whereas the financial year 1970-71 ended with September 1971, the financial year 1971-72 ended with December 1972. However, in the financial year 1971-72 as a whole, (eliminating broadly the effects of the banks strike) the Government's recourse to the banking system would not have been substantially higher than the amount of Rs. 100 million originally provided for in the Budget.

There has been some improvement in bank credit to the private sector in the period under review, but a good part of it represents advances against goods receipts relating to the sale of paddy under the Guaranteed Price Scheme. These advances rose by Rs. 74.2 million as against a decline of Rs. 56.4 million in the corresponding period in 1971. As explained elsewhere in this Report, the high level of bank credit for paddy purchases in 1972 was mainly attributable to procedural changes in financing paddy purchases consequent on the establishment of the Paddy Marketing Board.

While bank credit to public corporations rose by Rs. 6.0 million credit to the rest of the private sector rose significantly by Rs. 41.3 million, when compared with the increase of Rs. 7.8 million in the corresponding period in 1971. A notable feature in bank credit to the private sector in the period under review was the arrest of the rapidly increasing trend in the consumption and 'other' loans witnessed since 1970. These loans declined marginally in the second quarter of 1972. The accumulation of time and savings deposits of the private sector with the commercial banks was considerably lower than in the 1971 period.

(c) The Balance of Payments-1972

The underlying unfavourable trend in the balance of payments continued in 1972. Once again, export earnings were inadequate to finance the austere import programme. Although export earnings, both visible and invisible, increased from Rs. 2,265 million in 1971 to Rs. 2,336 million in 1972, payments for imports-both of visibles and invisibles-rose even faster from Rs. 2,586 million to Rs. 2,687 million. The moderating influence of grants from foreign governments reduced the deficit on current account to Rs. 269 million (from the trade deficit of Rs. 302 million) in 1972. Still, compared with the deficit for 1971 of Rs. 216 million, the out-turn in 1972 is a deterioration.

Inflows of long-term investment, banking and portfolio capital, on a year to year basis, can, of course, compensate for any deficit in the current account of the balance of payments and could yet transform the overall balance of payments into a healthy one, but such capital movements have never been significant in Sri Lanka. Such capital as did come in to finance payments beyond the level permitted by earnings has been the outcome of negotiations entered directly into with foreign governments and multi-lateral lending agencies. Sri Lanka in 1972 was no nearer a payments equilibrium than it was a decade ago when policy options to counter the situation were already clear.

Though net long-term capital inflow to Sri Lanka (comprising mainly commodity and project aid) amounting to Rs. 294 million were adequate to cover the current account deficit, they were at a much reduced level compared with 1971 when the total (net of repayments) reached Rs. 404 million. The financing margin being so thin, the country had to rely on short-term credit, partly to meet the lag between payments and receipts, and partly to meet the repayment obligations on short-term credits outstanding. However, receipts on transactions with the International Monetary Fund totalling Rs. 163 million (consisting of drawings under the Standby and under the Scheme of Compensatory Financing of Export Fluctuations) and the Special Drawing Rights allocation of Rs. 62 million considerably eased the situation, which in large measure helped to increase the external assets by Rs. 187 million.

The following table indicates the methods of financing the resource gap.

TABLE I-3

Sri Lanka's External Resource Gap and Modes of Financing - 1972

Rupees Million

	1970	1971	1972*
1. Exports	2,017	1,930	1,963
2. Imports	2,332	2,217	2,265
3. Trade balance	- 315	- 287	- 302
4. Investment income	- 42	- 29	- 28
5. Interest payments	- 100	- 92	- 109
6. I.M.F. repurchases	- 161	- 145	- 170
7. Debt repayments including short-term and/or repatriation of capital	- 495	- 906	- 782
8. Other current account transactions	+ 32	- 34	+ 88
Total (3 to 8)	- 1,081	- 1,372	- 1,303
Financed by:			
Commodity aid	263	260	317
Project aid	35	86	97
Other aid	—	152	—
Suppliers' credits	85	58	72
I.M.F. purchases	57	83	163
Bank borrowings	123	—	12
Short term credits	434	658	593
Bilateral balances .. .	- 75	- 57	- 11
External assets	- 25	- 96	- 229
Grants	75	105	82
Private capital	8	25	51
Other	52	41	88
Special Drawing Rights	78	63	62
Errors and Omissions	- 29	- 6	6
Total	1,081	1,372	1,303

1. Provisional.

It can be seen from the above table that short term trade credit is the most important single source for financing the resource gap; its relative position, however, declined from 48 per cent in 1971 to 46 per cent in 1972. Other important sources of financing were commodity aid, which increased its relative position by 5 percentage points from 19 per cent in 1971 to 24 per cent in 1972, and I. M. F. drawings, the importance of which rose from 6 per cent in 1971 to 12.5 per cent in 1972.

Merchandise imports and imports of services amounted to Rs. 2,628 million, while exports of goods and services amounted to Rs. 2,311 million. Total debt servicing (excluding short term credits) was 20 per cent of export earnings, while in 1971 it was 16 per cent.

Two of the growing enterprises are tourism and the export of gems. Tourist arrivals are on a steadily increasing trend and earnings on this account have increased from Rs. 20 million in 1971 to an estimated Rs. 32 million in 1972. Growth of tourism has the direct and indirect effects of inducing demand for various types of urban services, such as, housing and construction, personal and distribution services. The export of gems through official channels is now on the increase, and it is recorded that in 1972 nearly Rs. 12.3 million worth of gems had been exported, compared to an export value of Rs. 3.4 million only, in 1971.

(d) Prices

Price developments in 1972, as reflected by the Colombo Consumers' Price Index, showed a significant difference from those of the previous year. The average of the Colombo Consumer's Price Index went up by 6.3 per cent in 1972, compared to a modest increase of 2.7 per cent in 1971. It should, however, be noted that there was a steady increase in prices throughout the year under review. The index itself, though it may not reflect the actual increase in prices, was kept in check by price control measures, rationing and subsidising of items that entered mass consumption. However, to promote local production through price incentives, prices of a few items, including red onions and chillies, were de-controlled. Nevertheless, the large shortages relative to demand pushed up prices. Shortages of imported goods and of domestically produced items, and several other factors exerted an upward pressure on prices. The currency realignments together with the adjustment of freight rates was intensified by the inflationary tendencies that prevailed abroad. The increase in Business Turnover Tax and the FEEC rate influenced the increase in prices in the last quarter of the year.

The full impact of some of these factors on prices may not have been experienced in the year under review. In the absence of a reliable indicator the impact of monetary forces cannot be measured in any precise manner. The banks strike during the last quarter of 1972 would also tend to conceal any possible effects the monetary assets would have on prices. Available data, however, indicate that money supply rose by 15.3 per cent in 1972 compared to an increase in G. N. P. of 7.1 per cent. Thus, in the last quarter of 1972 pressure on prices emanated both from a higher velocity of circulation of money and a larger volume of money pumped into the economy to meet a temporary cash shortage of the Government resulting from the banks strike.

3. POLICIES AND MEASURES

(a) Monetary Policy

Viewed in the perspective of persistent deficits in the balance of payments and an excess liquidity in the banking system, monetary policy in 1972 had to continue to be restrictive. The continuing sluggishness in the economy, on the other hand, called for some relaxation of existing restrictions. Since a determined effort was being made by the Government to keep bank borrowing within limits, the Central Bank considered that a limited expansion in bank credit to the private sector would be consistent with the objective of monetary stability. The ceilings which were in force in the past few years were lifted with effect from 1st April, 1972. However, in order to guard against any undue expansion, the reserve ratios were maintained at the existing levels. Banks were also asked to refrain from increasing credit for non-essential purposes, such as, consumption, speculative stock building, etc., over the level of such credit as on 31st March, 1972. Bank Rate continued to remain at 6½ per cent.

(b) The Exchange Rate

The United Kingdom decided to float the Pound Sterling with effect from June 23, 1972. The Ceylon rupee, which had been linked to the U. S. dollar from November 6, 1971, was re-linked to the Pound Sterling as from 10th July, 1972 at the existing parity between the Ceylon rupee and the Pound Sterling, and parities with all currencies were fixed from time to time on the basis of their values in international foreign exchange markets.

4. ECONOMIC PROBLEMS IN 1972

(a) Introduction

The Annual Report for 1971 drew attention to the problem of mobilising resources to finance the Five Year Plan. The experience gained from the first year of the Plan has indicated the need to accelerate the tempo of utilization of resources, whilst underlining the critical internal and external bottlenecks that tend to stand in the way of realisation of the Plan targets.

It is not always possible to assess the performance of the Plan by using aggregate measures of economic growth, such as, the growth of Gross National Product or of per capita income. It is well understood that simplistic notions of national income analysis are inadequate measures of economic growth. The non-achievement of overall growth targets within a short period would also indicate that a larger number of instruments are required to be applied in the following years. A case in point is afforded by the overall growth of 2.4 per cent in Gross Domestic Product in 1972, compared to the Plan target of 6.1 per cent. This indicates that in the next four years the average rate of growth has to be stepped up to 7.0 per cent annually to keep to the required target. However, this aggregate measure very often overlooks or under-estimates the contributions of planning in the provision of social infra-structure, the redistribution of income and a higher degree of social justice. Furthermore, an assessment of the Plan from only one year of its operation may not be meaningful as the targets can fluctuate from year to year so as to yield the average rate of growth as planned.

In the first year itself plan implementation was beset with a number of problems. The problems are generally divided into endogenous and exogenous factors. The endogenous or internal factors range from the efficiency of the operations of the planning machinery to the support given to it by the people themselves. The exogenous or external factors are those that are largely beyond the control of Sri Lanka acting alone. Some of them may have arisen after the Plan was drawn up so that it was not possible to take note of them adequately. There is no doubt that a combination of both internal and external factors tend to reinforce each other and multiply the problems by altering the context in which the Plan has to be implemented. Evidently, the internal factors have to be evaluated after taking into account the relatively short period that has elapsed since the Plan become operative.

Quarterly progress reports are prepared to give an indication of the success in the drive towards reaching certain targets. The quality of the basic information available needs to be improved and reviewed regularly. Throughout the period of implementation of a Plan adequate measures have to be taken to ensure the progress of the Plan. For this purpose various types of quality statistics pertaining to the projects at every stage of their execution have to be collected, analysed and evaluated. There are serious deficiencies in the quantity, quality and timeliness of data that are basic to the reviewing of economic progress. For instance, detailed statistics on Sri Lanka's export and import trade are not available from 1970. One reason for this is that proper arrangements have not been made to enable those who provide the data to use them as a guide in decision making. The quality of the data is uneven. Much ground remains to be covered in the collection and refining of statistical data on a timely basis, so that a meaningful evaluation of economic performance could be undertaken regularly.

The rate of growth of Gross Domestic Product and a few other macroeconomic variables in 1972 are compared below with the Plan targets and the pre-Plan attainments.

TABLE I - 4

Pre-Plan, Plan and Actual Performance in 1972 of Selected Macro-Economic Variables (at constant prices)

	Pre-Plan 1961-71	Plan 1972-76	1972 Performance over 1971
Gross Domestic Product, at factor cost ..	4·3	6·1	2·5
Private Consumption ..	3·9	4·1	5·8
Government Consumption ..	4·6	5·9	3·0
Gross Investment ..	5·2	5·2	-15·1
Exports of Goods and Services .	1·1	6·9	2·4
Imports of Goods and Services ..	-4·0	2·6	-0·2

It can be seen that the performance of most economic variables was below planned targets. In the first place, though the year 1972 is considered the first year of the Plan, actual plan implementation was delayed because of the need for stock taking and adjustment after the insurrection of April 1971. On top of this, a severe drought affected major agricultural commodities, thus reducing domestic supplies, exportable surpluses and the amount of foreign exchange that could have been earned or saved.

Total investment fell short of the planned ratio of 18 per cent of Gross Domestic Product by 3 percentage points. This decline will cause future growth to be adversely affected with its attendant repercussions on income, employment and savings.

(b) Agriculture

In the absence of reliable estimates of investment by industrial origin (or sectors), it is not possible to assess the extent of realisation of agricultural investment targets. However, data on replanting of major export crops indicate a shortfall from the planned investment levels. In the case of tea replanting, about 85 per cent of the target was realised in 1972, while rubber replanting fell short of the target by nearly 42 per cent. The coconut replanting scheme also did not work according to plan as indicated by the number of seedlings issued, which was only 79 per cent of the target for 1972.

The rate of growth of investment in 1972 was influenced by a number of factors, chief among which were the uncertainties of market conditions, availability of investment finance and investment attitudes. The demand for most of the export products was not steady and there were no immediate prospects that the position will improve. Low prices for these products reduced the profit margins of most producers to very low levels, while marginal producers either incurred losses or went out of production. The uncertainties created by land reforms were intensified by the drought conditions that prevailed. Availability of investment finance was limited because of the decline in profits and the difficulties of obtaining investible funds on mortgages of agricultural land alone.

There was an increase in agricultural output by 3.1 per cent in 1972. This increase was caused mainly by a rise in output of milk, fish, eggs, coconut and subsidiary food crops, despite a fall in production of tea, rubber and paddy. The severe drought conditions reduced the output of tea and paddy. The decline in the rate of fertilizer application also affected output adversely. Producers of export crops reduced their fertilizer intake not only because of the drought conditions and low prices, but also because of shortages of working capital.

The severe drought of 1972 reduced the paddy output well below the Plan target. In addition, one disturbing feature that is noticeable is the low rate of utilization of agricultural credit. Total credit utilization for cultivation of paddy declined from a peak of Rs. 72.7 million in 1967/68 to Rs. 26.4 million in 1971/72, mainly due to the high rate of default, which in turn made the farmer ineligible for further loans. The Survey of Defaults, carried out by the Central Bank in 1972, indicates that one of the main causes for the low rate of repayment was the inadequate efforts made to recover these loans even from the more prosperous farmers. Viewed against the context of low fertilizer application and fluctuation in the utilization of material inputs, inadequate use of rural credit would have intensified the decline in production in 1972. The target for paddy output in 1972 was 78 million bushels, but the amount actually realised was 62.9 million bushels.

In the case of subsidiary food crops the rate of growth in output was 4·4 per cent, compared to an expected rate of 5·5 per cent. It should be noted that the output of subsidiary food crops have shown a rapidly rising trend in the past, but its rate of growth was checked in 1972 mainly by the adverse weather conditions.

The most important thrust of agricultural strategy, as set out by the Plan, was land distribution towards more labour intensive agricultural holdings. Accordingly, the Land Reform Law, No. 1 of 1972 was passed by the National State Assembly in August. These land reforms aim at improving the legal and economic status of the tenant, establishing well defined ceilings to the ownership of land, distributing excess land among the landless peasantry and reducing the inequality of land ownership and of income distribution.

Land owned by public companies, viharagam or dewalagam and religious institutions (as defined) will not come under the stipulations of the Land Reform Law. In all other cases, the ceiling was fixed at 25 acres for paddy lands and 50 acres for other lands. Though nearly 65 per cent of the holdings and 15 per cent of the area were under 2½ acres in extent, no programme for consolidating such holdings has been designed under the Land Reform Law. The Commission is empowered to alienate the land in the best possible way, so as to increase production, productivity and employment.

Lands vested in the Commission will receive compensation, partly in cash and partly in land reform bonds, in such proportion as may be determined in concurrence with the Minister of Finance. Land reform bonds will be issued by the Central Bank and will have a maturity of 25 years and carry an interest rate of 7 per cent per annum.

Very often the large farmers lack adequate capital and managerial ability to make their farms economically viable to utilize all available capacity most effectively to raise employment, income and output. Small holdings have been found to be viable alternative to large farms in most countries that carried out land reforms. At the very beginning the marketed output may fall because small farmers often consume a large volume of their own production. This would mean that total output will be kept almost constant, if not more, in the short run, whilst raising the standard of living of the bulk of farmers. A short term loss in output, however, is possible when large farms in which output per acre is higher than the output that is likely to be obtained on a small farm at present are redistributed. However, in the long run, economically viable small holdings will prevent the build-up of excess capacity in agriculture by more intensive land use, so that a large number of families geared to labour intensive methods can be settled. It is estimated that the area available for redistribution will be 450,000 to 500,000 acres. Assuming that an economically viable holding is between 3 and 5 acres, eventually 100,000 to 150,000 families can be settled under the scheme. Initially, the support necessary to implement such a programme, both administratively and financially, would be rather demanding.

Very often institutional changes that accompany structural reforms add a severe strain on the administration in carrying out the basic objectives of policy. However, the success of land reforms will depend on the successful co-ordination and implementation of the whole lot of agrarian reforms. These include the provision of credit, expansion of infra-structure and super-structure, technical, educational and training facilities, extension work and community development schemes.

(c) Industry

As in the case of agriculture, investment data on private sector industry are not available. Investment by public corporations and by the government in industrial ventures indicated a fall of 13.1 per cent in 1972 over the 1971 level.

The slower growth or near stagnation or decline in investment can be traced to a number of factors. The most important single cause was the inadequate and erratic supply of raw materials due to the balance of payments situation. Internal resources of firms and foreign exchange funds available for maintenance of supplies and expansion declined markedly. The cumulative effect of uncertainties regarding the private sector would have resulted in a postponement of their investment decisions. Successive currency realignments increased the cost of imported raw materials, thus raising the cost of production. This was mainly intensified by a heavy dependence on imported raw materials. In 1972, nearly 77 per cent of the raw materials used was imported.

A capital saving way of increasing employment was by fuller utilization of existing capacity. Firstly, acute foreign exchange scarcity has compelled the government to curtail import allocations to industry, thus forcing them to cut down production and making it impossible to exploit one of the significant capital saving ways of expanding employment.

Secondly, the poor perfomance of the agricultural sector in the previous year reduced the demand generated by this sector for industrial products. The following table shows that in 1968–1970 the utilization of imported raw materials was well below the amount needed for production at full capacity.

TABLE I-5

Raw Material Utilization – Value of Raw Materials needed and actually used in 1968–70

Industrial Category (1)	Value of imported raw materials needed for production at full capacity (shift) Rs. Mn. (2)	Value of imported raw materials used Rs. Mn. (3)	3 as percentage of 2 (4)
Food, Beverages and Tobacco ..	21·5	8·8	41
Textiles, Wearing Apparel, Made up Garments ..	36·5	14·3	39
Chemicals and Chemical Products ..	20·0	12·4	62
Metal Products	29·4	20·3	69
Machinery, Transport and Equipment ..	37·6	8·4	22
Electrical Machinery, Apparatus and Appliances ..	93·8	15·8	17
Manufactured products, n.e.s ..	9·7	2·9	30

Source: Ministry of Industries and Scientific Affairs.

Since 1968–70 there were further cuts in the allocation of import requirements to industry. In 1972 (based on 1971 allocations) vital industries were given 100 per cent import allocations of raw materials, essential industries 50 per cent, semi-essential industries 40 per cent, while non-essential industries received 30 per cent.

Evidently, it was the shortage of imported raw materials that served as the biggest constraint impeding industrial expansion.

Industrial expansion has to be achieved by reducing the capital intensity of projects and making them increasingly labour intensive, using local raw materials on a large scale and creating new capacity for agro-based industries. Employment expansion has to take place steadily by ending stagnation in production and investment.

Clearly, the structure of manufacturing industry has encouraged the use of imported inputs, which has not shown any tendency to decline in favour of local raw materials. Industries were able to produce and survive largely with the help of foreign assistance in the form of commodity loans and spares for machinery. When the volume of such aid falls and in the absence of an outward looking export oriented growth, the production volume will be depressed. The increase in volume of output was only 2.3 per cent compared to an expected growth of 10 per cent.

In this respect speeding up of the development of small scale industries is to be planned and carried out. Apart from the need to have a close relationship between the small and large scale industries, as in tobacco, through sub contracting, this sector needs to be given every assistance to process indigenous raw materials, stimulate production of small tools and implements used in agriculture and assist them so as to enable them to adapt to changing market demand conditions.

The link between agriculture and industry, by which the farmers are provided with inputs and consumption goods put out by industry, has to be maintained and serviced regularly if the annual rate of growth of 10 per cent as envisaged in the Plan is to be maintained on a continuing basis. Since the biggest impediment to industrial expansion, within the context of a heavily import dependent inward looking industrial structure, is the scarcity of foreign exchange vigorous efforts have to be made to re-structure the industrial base.

(d) Balance of Payments

Sri Lanka's experience in 1972 highlights the exogenous problems, the solution of which (or mitigation of their adverse influences) is fundamental to the promotion of long term growth. The Annual Reports of the past years had emphasised, among other things, the need to have fiscal and monetary restraints to prevent leakages of foreign exchange and undue pressures on the price level. Sri Lanka has taken meaningful steps to prevent persistent deficits in the balance of payments by way of monetary and fiscal measures. But such measures alone could not prevent serious balance of payments deficits.

This year's performance could be regarded as a continuation of a trend influenced by structural and institutional factors created by scant diversification of exports. The problem of export promotion was given due emphasis by the establishment of the Export Promotion Council which aims at removing the short-comings arising from the lack of unified national export promotion policies.

However, the present trend of major exports, if it continues in the next few years of the Plan period, would result in a large deficit that will seriously impair import capacity. The deficit will be further inflated by debt servicing and interest payment on investments.

The rise in import values, adverse movements in terms of trade and a rise in debt servicing burden have all contributed their share to the growing crisis in the payments situation. The following table brings out clearly that the foreign exchange earnings in 1972 were inadequate to meet the import payments of the country.

Table I - 6

Foreign Exchange Earnings and Expenditure on Selected Items - 1972

	Rs. Million
1. Total foreign exchange earnings	2,337
2. Total imports	2,568
3. Debt servicing (excludes short term liabilities) ..	464
4. Total payments	3,032

As the balance of payments situation worsened, import capacity declined and a higher rate of borrowing was necessary. Export promotion and import substitution programmes afford medium and long term solutions. In the meantime income stability and employment expansion have to be sustained by maintaining an adequate rate of economic growth. Sri Lanka has been most unfortunate because there has been not only a diversion of the structure of demand away from her major export products but also the terms of trade have been moving heavily against her. This would mean that the period of adjustment will be a long one. Sri Lanka's export capacity has to be maintained in order to enable her to carry through the programme of development prescribed in the Five Year Plan.

It is not merely that Sri Lanka's import capacity has been steadily eroded away due to declining export earnings (in foreign exchange terms) and increasing debt servicing, but equally, due to the rise in import prices and a rapidly worsening in the terms of trade which had reduced her import capacity. This background has dictated that Sri Lanka's development strategy should be a three-pronged one.

On the exports front there is an urgent need to reverse the declining trend in earnings. It is essentially in this sphere that the more fundamental and long term solution to the problem of import capacity may be found. Past Reports have outlined the policy developments and success achieved in this field. However, the results have yet to make a significant impact on the balance of payments and the conclusion is inescapable that the wait can be long. In the more immediate context a source of grave concern is the traditional export sector - tea, rubber and coconut. Being accustomed to assume that these industries will at least maintain their rising output record, it is depressing to find both, tea and rubber industries, are unable to maintain their production targets. Production of both tea and rubber declined last year. It would appear that due to decreasing returns, producers are economising on operating costs, thus leading to a lower output. Fertilizer application to tea, rubber and coconut properties has declined. Investment in these industries is falling with all its implications for the future. It is of national importance that an indifferent production effort should not lead to a fall in export earnings. Measures to forestall this must centre on improving the average returns (higher operating profits) to producers.

Obtaining external capital to prop up import capacity is the second-prong in this development strategy. Though in no way minimising the role it plays in Sri Lanka's present balance of payments, it is in her interest to limit reliance on aid to the absolute minimum. Sri Lanka has little control either over the quantum of its availability or the type of assistance. It depends on the foreign policies of donors, the mood of their legislators and on their balance of payments situation. Sri Lanka's credit-worthiness is also reviewed by the donors from year to year. Being the outcome of periodic negotiations, there is a lack of regularity in its flow. It also weakens Sri Lanka's ability to purchase from the cheapest source.

It is generally believed that a heavy dependence on foreign aid reduces the volume of domestic savings. This has been true of most countries in the past. Adoption of policies for economic expansion tend to get postponed until the donors have made their commitments. The Plan, therefore, expects to reduce the dependence on aid, but the realisation of this objective has been mostly vitiated by exogenous factors. Therefore foreign aid has to be treated as a kind of first-aid required to resuscitate the economy and provide a healthy balance of payments and economic expansion without reducing or minimising efforts required to mobilise Sri Lanka's own resources.

Hence, the third-prong of Sri Lanka's development strategy viz. import substitution, becomes crucially important. Though the import programme has been pruned to admit only of essentials, a combination of unfortunate circumstances – steadily rising prices of manufactured goods imports and latterly of agricultural food imports – has reduced to a most inadequate level the imports of industrial raw materials and capital equipment. Low, and in many instances technologically unwise, capacity utilization in industry is widespread. If the best long-term prospects for development rest on industry, a process of emancipation of industry from its present constraints must be set in motion. It is from this point of view that a critical look is needed at the items of mass consumption – rice, flour and sugar – with a view to effecting notable economies. About Rs. 750 million (or a third of the total import bill) is spent on these three commodities. No doubt a higher level of domestic production will reduce the import requirements. This can affect the balance of payments only with a lag. However, a breakthrough on consumption levels can have an immediate and lasting effect on the balance of payments. For example, if the community faces up to the realities of the world supplies position and the conditions in the neighbouring countries in particular, and settles for lower consumption of imported foods by substituting local equivalents, the benefit to the balance of payments can be substantial.

In an unchanged situation, the "external bottleneck" will severely limit growth. A mobilization of domestic savings alone is not a sufficient condition for achieving a satisfactory rate of economic growth. Effective development, particularly industrialisation, is dependent on a continuing flow of imported raw materials etc. An increase in domestic savings adequate to finance a larger volume of physical investment need not by itself ensure that the type of investment appropriate to rapid growth would take place if the import requirements that are technologically necessary for the process are unobtainable. But in obtaining foreign assistance to support the development efforts, Sri Lanka has to be cautious lest she is pushed into a position, by reason of her payments difficulties to have recourse to external credit of a type that will make her even more import dependent.