(H) BALANCE OF PAYMENTS AND EXTERNAL ASSETS

Detailed statistics of Sri Lanka 's balance of payments and external assets are available in Tables 44 to 48 in Appendix III. Balance of payments data are largely derived from exchange control records of actual receipts and payments during the year, and are supplemented by information from other sources such as the Ministry of Planning and Economic Affairs and the Ceylon Petroleum Corporation. These figures may differ from trade statistics based on Customs returns as Customs statistics reflect physical movements of commodities while exchange control statistics record the receipt/payment of money, and usually there is a time-lag between the two aspects.

Overall Developments

Sri Lanka's balance of payments was subject to exceptional influences in 1974. On the import side very large increases in prices of oil, foodstuffs and other raw materials called for a substantial increase in the import bill. On the export side although the prices of most commodities increased, the lower volume of exports did not give the country the full benefit from increased prices.

If the full impact of the increase in import prices was allowed to reflect on import levels a drastic lowering of living standards would have ensued. However, with the assistance of foreign aid, short term credits and resources made available by the International Monetary Fund under the Oil Facility, Sri Lanka was able to maintain a certain minimum level of imports for purposes of consumption and economic activity. The outcome of the effort to maintain this minimum level of imports was a trade deficit of Rs. 1, 227 millon, the largest ever recorded. Compared with 1973 when the deficit was Rs. 299 million, this is a very marked deterioration. Other transactions in the current account of the balance of payments, however, resulted in a surplus. The most important from among these, was the receipt of outright grants from foreign governments valued at Rs. 254 million which is more than double the last year's level. The overall surplus in the invisibles account of the balance of payments, thus, brought down the current account deficit to Rs. 899 million.

Sri Lanka's balance of payments, has traditionally been in deficit as the country has consistently spent in excess of its income. Although the 1974 outturn conforms to this pattern, the size of the deficit and the fact that its rapid deterioration came after four years of steady improvement are significant features. The foreign credits which have been made available to finance deficits in the balance of payments have been an important means of drafting external resources for development. Thus, past data show that gross domestic capital formation has tended to move concurrently with the current account deficit. Up to 1969/70, when the current account deficit went on increasing, gross domestic capital formation, too, increased, and since then with the progressive decline in the deficit, the rate of capital formation also has steadily declined. But in 1974, although the current account deficit greatly increased, gross domestic capital formation has fallen because expenditure in excess of income has been mainly for consumption.

A deficit of the magnitude that confronted the country in 1974 required that the sources of finance had to be more diverse than in previous years. In earlier years transactions in the non-monetary capital sector, consisting mainly of foreign aid and

TABLE II (H) I

Sri Lanka's Balance of Payments

Rs. Million

Year	Trade Balance	Net Invisibles including Transfer Payments	Balance on Current Account	Net Long-term Capital	Basic balance
1958 ..	− 89	− 64	− 153	+ 8	− 145
1959 ..	− 183	− 25	− 208	+ 32	− 176
1960 ..	− 210	− 11	− 221	+ 22	− 199
1961 ..	− 86	− 7	− 93	+ 11	− 82
1962 ..	− 143	+ 3	− 140	+ 39	− 101
1963 ..	− 161	− 7	− 168	+ 80	− 88
1964 ..	− 193	+ 33	− 160	+ 8	− 152
1965 ..	− 13	+ 72	+ 59	+ 58	+ 117
1966 ..	− 344	+ 54	− 290	+ 137	− 153
1967 ..	− 335	+ 46	− 289	+ 161	− 128
1968 ..	− 380	+ 25	− 355	+ 224	− 131
1969 ..	− 746	− 51	− 797	+ 275	− 522
1970 ..	− 315	− 35	− 350	+ 184	− 166
1971 ..	− 287	+ 71	− 216	+ 404	+ 188
1972 ..	− 255	+ 59	− 196	+ 292	+ 96
1973 ..	− 299	+ 138	− 161	+ 190	+ 29
1974 (*a*) ..	− 1,227	+ 328	− 899	+ 265	− 634

(*a*) Provisional

Source: Central Bank of Ceylon

short-term and suppliers' credit arrangements, were adequate to bridge this deficit. These were supplemented by purchases from the IMF or borrowings from foreign commercial banks which helped to satisfy temporary requirements for liquid resources. In 1974, however, as foreign aid and credits from the usual sources were inadequate, there was extensive recourse to assistance consisting of credits from the IMF and the oil exporting countries, and the use of balances lying to Sri Lanka's favour in bilateral trade and payments agreements. By preferring to incur monetary liabilities, rather than using monetary assets to finance the current account deficit, Sri Lanka was able to avoid using external assets; in fact gross external assets increased slightly from Rs. 851 million at the beginning of the year to Rs. 889 million at the end of the year.

A. DETAILED TRENDS

I. Merchandise Account

The deficit in the merchandise account of the balance of payments in 1974 was the worst ever recorded. The deficit for 1974 of Rs. 1,227 million shows a four-fold increase when compared with the deficit for 1973. The deficit arose despite a significantly higher level of earnings from exports and is explained in large part by the even larger increase in the import bill.

(I) Exports

The increase in export earnings evidenced in 1973 was even more pronounced in 1974. In 1974 total earnings were Rs. 3,376 million compared with Rs. 2,346 in 1973 and only Rs. 1,898 million in 1972. The higher earnings were the outcome of favourable prices for practically all export commodities. The breakdown of export earnings on an exchange recorded basis by major categories and the relative importance of each category is as follows: Tea Rs. 1,367 million – 40 per cent; Rubber Rs. 746 million–22per cent; Coconut Products (Copra, Desiccated coconut and oil) Rs. 451 million–13 per cent; Gems and Precious Stones Rs. 100 million– 3 per cent; Miscellaneous Industrial and Agricultural commodities (including by-products of petroleum) Rs. 712 million – 21 per cent.

(a) Plantation Sector

Despite the higher level of prices for nearly all tree crop products the response of output to prices was poor and output declined appreciably. In the commodity boom in 1973 tea prices remained depressed, but a significant rise in prices from early 1974 bought about a belated improvement in export earnings. Rubber benefited from the boom in primary commodities from the early part of 1973. Prices improved further in early 1974 in the immediate aftermath of the abrupt rise in oil prices in 1974. Although average rubber prices in 1974 as a whole were higher than in 1973, from mid-1974 onwards rubber prices have been declining steeply. In 1973 export volume responded to higher prices through intensive tapping; however, in 1974 production fell sharply. Despite the latter, higher average prices resulted in total earnings from rubber increasing from Rs. 519 million in 1973 to Rs. 746 million in 1974. The output of coconut in 1974 was a third below the high level reached in 1972. Consequently, the industry failed to benefit fully from the exceptionally

BALANCE OF

Rupees

	1973 Credit	1973 Debit	1973 Net
1. Merchandise Account			
Exports (f.o.b.)	2,346		
Imports (c.i.f.) (own resources)		1,986	
(Aid Imports & Suppliers' Credits)* ..		658	
Total Imports		2,644	
Trade balance (own resources)			(+360)
Trade balance (all imports)			—298
2. Services Account			
Non-monetary gold	—	—	—
Port, transportation and insurance ..	177	62	+115
Foreign Travel ..	59	10	+ 49
Investment income	17	127	—110
(i) Profits & dividends	1	19	— 18
(ii) Other (interest)	16	108	— 92
Government Expenditure n.i.e.	33	20	+ 13
Miscellaneous Services	103	115	+ 12
Private transfers	48	46	+ 2
Total Services	437	380	+ 57
3. Total Current Account (own resources) ..	(2,783)	(2,366)	(+417)
Total Current Account (all Items)	2,783	3,024	—241
4. Capital Payment.	—	1,282	—1,282
Loans	—	146	—146
Suppliers' credits	—	95	— 95
Short-term credits	—	644	—644
Asian Development Bank	—	—	—
Private Capital	—	5	—5
I. M. F.	—	169	—169
Bank borrowings	—	112	—112
Other	—	111	—111
Total Current & Capital Payments (own resources) ..			(—865)
Total Current & Capital Payments (all items) ..			—1,523
5. Financing			
I.M.F. Drawings	137	—	+137
Oil Facility drawings	—	—	—
Borrowings from abroad	—	—	—
Bilateral balances	35	—	+ 35
Suppliers' credits	240	—	+240
Short-term credits	781	—	+781
External Assets	—	125	—125
Commodity Aid	210	—	+210
Project & Other Aid	125	—	+125
Grants	83	—	+ 83
Private Capital	6	—	+ 6
Other	14	—	+ 14
Special Drawing Rights	—	—	—
Errors & Omissions	17	—	+ 17
Total financing	1648	125	+1523

(*a*) Provisional.
Figures have been rounded off
* Includes grants

TABLE (II) H 2

PAYMENTS 1973—1974

Million			SDRs Million					
1974(a)			1973+			1974 (a) +		
Credit	Debit	Net	Credit	Debit	Net	Credit	Debit	Net
3,376			309			421		
	3,489			261			435	
	1,114			87			139	
	4,603			348			574	
		(—113)			(+48)			(—14)
		—1,227			—39			—153
—	—	—	—	—	—	—	—	—
173	66	+107	23	8	+ 15	22	8	+ 14
95	9	+ 86	8	1	+ 7	12	1	+ 11
37	148	—111	2	17	— 15	5	19	— 14
—	14	— 14	—	3	— 3	—	2	— 2
37	134	— 97	2	14	— 12	5	17	— 12
33	25	+ 8	4	3	+ 1	4	3	+ 1
107	120	— 13	14	15	— 1	13	15	— 2
54	56	— 2	6	6	—	7	7	—
499	424	+ 85	57	50	+ 7	62	52	+ 10
(3,875)	(3,913)	(—38)	(366)	(311)	(+55)	(483)	(487)	(—4)
3,875	5,027	—1,152	366	398	— 32	483	626	—143
—	1364	—1364	—	169	—169	—	170	—170
—	173	—173	—	19	— 19	—	22	— 22
—	214	—214	—	13	— 13	—	27	— 27
—	788	—788	—	85	— 85	—	98	— 98
—	3	— 3	—	—	—	—	—	—
—	4	— 4	—	—	—	—	—	—
—	162	—162	—	22	— 22	—	20	— 20
—	—	—	—	15	— 15	—	—	—
—	20	— 20	—	15	— 15	—	3	— 3
		(—1402)			(—114)			(—174)
		—2,516			—201			— 313
106	—	+106	18	—	+ 18	13	—	+ 13
271	—	+271	—	—	—	34	—	+ 34
16	—	+ 16	—	—	—	2	—	+ 2
167	—	+167	5	—	+ 5	21	—	+ 21
429	—	+429	32	—	+ 32	53	—	+ 53
836	—	+836	103	—	+103	104	—	+104
—	38	— 38	—	16	— 16	—	5	— 5
328	—	+328	28	—	+ 28	41	—	+ 41
103	—	+103	16	—	+ 16	13	—	+ 13
254	—	+254	11	—	+ 11	32	—	+ 32
12	—	+ 12	—	—	—	1	—	+ 1
16	—	+ 16	2	—	+ 2	2	—	+ 2
—	—	—	—	—	—	—	—	—
16	—	+ 16	2	—	+ 2	2	—	+ 2
2,554	38	+2,516	217	16	+201	318	5	+313

Source: Central Bank of Ceylon

+ Converted at weighted average annual rate of SL RS. 7.5993 = SDR 1 or SL RS. 1 = SDR 0.1316 for 1973 and at SL RS 8.0266 = SDR 1 or SL RS 1 = SDR 0.12458 for 1974

TABLE II (H) 3

External Resources and their Use

Item	Rupees Million				Percentage Share			
	1971	1972	1973	1974(a)	1971	1972	1973	1974(a)
A. Resources								
1. Merchandise exports f.o.b. ..	1,930	1,898	2,346	3,376	51	51	53	52
2. Services Account ..	333	332	437	499	9	9	10	8
3. Capital Inflow ..	628	525	424	697	16	14	10	11
of which:— ..								
(a) Loans [1] ..	346	402	335	431	9	11	8	7
(b) Other Aid [2] ..	152	13	—	—	4	—	—	—
(c) Grants [1] ..	105	100	83	254	3	3	2	4
(d) Private Capital ..	25	10	6	12	—	—	—	—
4. Short-term Liabilities ..	903	989	1,207	18,41	24	26	27	29
(a) Gross drawings from the International Monetary Fund ..	83	163	137	106	2	4	3	2
(b) Oil Facility Drawings ..	—	—	—	271	—	—	—	4
(c) Special Drawing Rights ..	63	62	—	—	2	2	—	—
(d) Increase in balances in Bilateral payments Agreements ..	—	—	35	167	—	—	1	3
(e) Borrowings from abroad ..	—	12	—	16	—	—	—	—
(f) Short-term Credits ..	658	593	781	836	17	16	18	13
(g) Suppliers' Credits ..	58	52	240	429	2	1	5	7
(h) Other ..	41	107	14	16	1	3	—	—
5. Decline in External Assts (net of Sterling Loan Sinking Funds) ..	—	—	—	—	—	—	—	—
Total	3,794	3,744	4,414	6,413	100	100	100	100
B. Use								
6. Merchandise imports c.i.f. ..	2,217	2,153	2,644	4,603	58	58	60	72
of which Aid ..	509	554	658	1,114	13	15	15	17
7. Services Account ..	367	373	380	424	10	10	9	7
of which ..								
(a) Investment Income ..	134	125	127	148	3	3	3	2
(b) Private transfers ..	40	50	46	56	1	1	1	1
8. Capital Amortization ..	132	133	151	177	3	4	3	3
(a) Official ..	96	125	146	173	2	3	3	3
(b) Private ..	36	8	5	4	1	1	—	—
9. Short-term Liabilities ..	976	873	1,131	1,187	26	22	25	18
(a) Repurchases from the IMF ..	145	170	169	162	4	5	4	3
(b) Decrease in balances in Bilateral Payments Agreements	57	11	—	—	2	2	2	—
(c) Borrowings from abroad ..	81	—	112	—	2	—	3	—
(d) Short-term Credits ..	614	570	644	788	16	15	15	12
(e) Suppliers' Credits ..	65	84	95	214	2	2	2	3
(f) Other ..	14	38	111	23	—	—	3	—
10. Increase in External Assets (net of Sterling Loan Sinking Funds) ..	89	224	121	—34	2	6	3	1
11. Balancing item	13	—12	—13	—12	—	—	—	—
Total ..	3,794	3,744	4,414	6,413	100	100	100	100

Sources: Central Bank of Ceylon

(*a*) Provisional.

1. Includes assistance received in the form of Project and Commodity Aid.

2. Currency Loan from the Peoples' Republic of China.

Figures have been rounded off.

favourable price trends prevailing during the year. All coconut products fetched higher prices, and total earnings from coconut rose from Rs. 146 million in 1973 to Rs. 451 million in 1974.

(b) Other Exports

Earnings from other exports reached Rs. 812 million – an increase of Rs. 155 million from the 1973 level.

The main item in this increase was re-exports of marine bunkers and aviation fuel, and exports of petroleum by-products like Naphtha. Export earnings from petroleum products were in the region of Rs. 350 million and was largely the result of the rise in the international cost of crude oil.

Earnings from coconut by-products, particularly fibre and shell charcoal increased substantially. Out of the total earnings of Rs. 217 million ascribed to this group, fibre accounted for Rs. 161 million and represents a doubling of the 1973 level. In 1974 exports of shell charcoal increased five-fold from a very small base to account for over one-fourth (Rs. 48 million) of the earnings from this group.

In 1974 there were higher export receipts from spices and most manufactured industrial goods. However, an exception to this general trend were earnings from gems and precious stones which fell from Rs. 140 million in 1973 to Rs. 100 million in 1974. The initial set-back to the surge in gem exports came in the aftermath of the abrupt rise in oil prices in early 1974 when demand from the industrially rich countries started to fall off. Although there were indications towards the middle of the year that the gem export trade was overcoming these adverse effects, earnings again fell back in the last three months probably as recession in the Industrial West began to curtail economic activity. Over the year as a whole although the volume exported was maintained, lower prices resulted in a fall in total earnings.

(2) Imports

(a) General

The effect on Sri Lanka of the world scarcities of agricultural food produce and the boom in raw material prices was reflected in the import bill for 1974 which reached Rs. 4,603 million; an increase of 80 per cent over the 1973 level of Rs. 2,644 million. The whole of this increase has been due to higher prices, while the volume of all imported goods other than a few miscellaneous items, has been noticeably lower. The all-imports volume index (1967 = 100) dropped from 79 to 56 between 1973 and 1974. The lower volume of food imports was due to a 10 per cent-reduction in rice imports and a 60 percent cut-back in sugar imports. The volume of imports of intermediate and investment goods also declined substantially.

The import price index (1967=100) increased from 209 in 1973 to 370 in 1974. The steepest price increase for any one commodity was for petroleum, although as a broad group, foodstuffs accounted for a larger share of the increase in the import bill. The cost of rice, flour and sugar alone, increased from Rs. 1,044 millon in 1973 to Rs. 1,769 million in 1974, despite considerable reductions in the quantites imported.

Underlying this were price increases for all three items; rice from an average of Rs. 807 per ton in 1973 to Rs. 2,461 in 1974; wheat flour from Rs. 1,144 per ton to Rs. 2,132 and sugar from Rs. 1,663 to Rs. 2,847.

The price increases and the resulting higher outlays on essential consumer goods and certain raw materials within a given import capacity inevitably affected the importation of capital equipment and investment goods. Whereas the total import bill increased 80 percent over the year, the proportion spent on capital goods increased by only 20 per cent to Rs. 460 million.

(b) The Oil Situation

The action of the Organisation of Petroleum Exporting Countries (OPEC) quadrupling the posted price for crude oil from US $ 2.50 per barrel in mid-1973 to US $ 10.65 per barrel (of light Arabian crude) in early 1974 resulted in Sri Lanka's import bill for petroleum and petroleum products going up from Rs. 293 million in 1973 to Rs. 905 million in 1974. Expenditure on petroleum alone absorbed over 20 per cent of the import bill in 1974. The cost of fertilizer imports, whose prices are directly influenced by crude oil prices, increased in the same period from Rs. 137 million to Rs. 250 million.

The impact on the balance of payments of fertilizer price increases is given by the difference between the import value before and after the price increase, i.e. Rs. 113 million. In the case of oil it is not easy to make such an accurate assessment because, apart from a small amount spent on imports of refined products, the bulk of the payment is for crude oil which is refined locally. A part of this is re-exported as fuel for foreign ships and aircraft, and another part as by-products, for example, Naphtha. Such re-exports were valued at Rs. 350 million in 1974. Determining the import cost of these items, i.e. the estimation of the crude oil content of such re-exports, would require the gross export value to be adjusted for domestic value added. Such an exercise is ruled out on technical grounds as crude oil does not lend itself wholly to producing one particular refined product without at the same time generating by-products in the refinery.

However, on the basis of an approximation of 60 per cent of the crude oil imports being retained locally, and after adjustment for imports of other refined products, the trade deficit resulting from the higher cost of crude oil amounts to about Rs. 560 million in 1974 as compared with Rs. 180 million for 1973. Increases in the import bill for oil and fertilizer in 1974, which totalled approximately Rs. 500 million are, therefore, seen to have accounted for over half the deterioration in the merchandise trade deficit from Rs. 298 million in 1973 to Rs. 1,227 million in 1974. The overall effects of the increase in oil prices on Sri Lanka's balance of payments are even greater, if account can be taken of its more indirect impact, that is, its effect on the cost structures of industrial countries, which have increased the cost to Sri Lanka of imports of manufactured goods and capital equipment, and on freight rates, which in turn have increased the c.i.f. cost of all imports.

II. Services and Transfers

The services account which provided positive support for Sri Lanka's balance of payments in 1973 made an even greater contribution in 1974. Including private transfers, the services account provided a sum of Rs. 75 million, and when official transfers, (Rs. 254 million) are added to this, the invisibles account as a whole on a net basis, contributed resources amounting to Rs. 328 million. It was this favourable outcome that helped, though moderately, to bring down the current account deficit to Rs. 899 million after merchandise transactions alone had caused a deficit of Rs. 1,227 million.

This improved performance has been the outcome primarily of higher receipts (Table II (H) 4). Compared with the previous year, receipts in 1974 increased by Rs. 62 million whereas payments increased by only Rs. 44 million. Receipts were higher from tourism (Rs. 36 million) and investment income from abroad (Rs. 20 million) while increases in expenditure were mainly in respect of interest payments and private transfers.

TABLE II (H) 4

Changes in Major Sectors in the Services Account 1973 and 1974

Rupees Million

	Credit			Debit			Balance	
	1973	1974*	Change	1973	1974*	Change	1973	1974*
Port, Transportation and Insurance	177	173	—4	62	66	+4	+115	+107
Foreign travel	59	95	+36	10	9	—1	+49	+86
Investment Income	17	37	+20	127	148	+21	—110	—111
(i) Profits and Dividends	1	—	—1	19	14	—5	—18	—14
(ii) Interest	16	37	+21	108	134	+26	—92	—97
Government Expenditure	33	33	—	20	25	+5	+13	+8
Miscellaneous Services	103	107	+4	115	120	+5	—12	—13
Private Transfers	48	54	+6	46	56	+10	+ 2	—2
Total	437	499	+62	380	424	+44	+57	+75

Source: Central Bank of Ceylon

* Provisional

(a) *Port, Transportation and Insurance*

The item port, transportation and insurance in Table II (H) 4 is made up of transactions on account of freight and merchandise insurance, passenger fares, port receipts/expenditure, and miscellaneous items. This account through successive surpluses of receipts over payments has contributed significantly to the balance of payments and has been one of the two main reasons why in the past the current account deficit has usually been lower than the trade deficit. (The other reason being the receipt of grants.) This situation is changing and there are indications to this effect in 1974. To some extent this is because, the surplus in this account is likely to be moderated (i) by the increase in payments on account of passenger fares paid to foreign aircraft and ships as a result of residents using foreign craft for travel; one-third of the total payments (Rs. 23 million) was on this account in 1974, and (ii) by expanding operations of local shipping fleets which result in expenses being incurred by such locally owned vessels in foreign ports*. This item included under port expenditure (debit) has increased from Rs. 11 million in 1971 to Rs. 16 million in 1974. The other reason for the decline in the relative importance of this account in the balance of payments, is the growth of the tourist industry.

(*b*) *Tourism*

Earnings from the tourist industry increased for the third year in succession in 1974. Total earnings during the year increased by 50 percent over the 1973 level to reach Rs. 95 million. As in the previous year, this has been the joint effect of a higher volume of tourist traffic and an increase in per head tourist expenditure in Sri Lanka.

The trend towards an increase in the volume of tourist traffic observed in recent years was evident in 1974 as well. The total number of tourists visiting the country reached 85,000 which is the highest figure recorded so far. A noteworthy feature was that whereas in 1974 there was a decline in world tourist traffic there was a substantial increase in the number of visitors to Sri Lanka. Apart from the latter consideration the sharp increase in earnings in 1974 is also explained by the higher level of per capita expenditure by tourists due to the rise in cost of tourist services.

Although the overall level and growth of tourist earnings in 1974 is encouraging, the outturn towards the end of the year was less favourable. The tourist season on a calendar year basis is from January to April and October to December. The average monthly earnings which were Rs. 11 million in the period January/April dipped to Rs. 6 million in the slack period from May to September. Thereafter, earnings failed to pick up from October when the season recommenced and average monthly earnings during the last quarter were as low as Rs. 7 million. It appears that the adverse impact on international tourism of the rise in costs due to energy crisis and inflation, combined with recession in the industrial countries, is now being felt in Sri Lanka. Sri Lanka's distance from the main sources of tourist traffic (North America, Western Europe and Japan) and considering the rise in transport costs is likely to affect the numbers coming from these countries. This is occurring at a time when the capacity is being expanded substantially, and can place Sri Lanka's tourist industry in a difficult situation.

(c) *Investment Income*

Receipts on account of investment income represent very largely the interest income from the investment of external assets in money markets abroad. These investments are mainly deposits of liquid balances in banks abroad and long-term

* This account also takes into consideration the freight earnings of local shipping companies in carrying cargo for foreigners (Item 3, Credit, Appendix Table 44). It does not, however, reveal the extent of foreign exchange saved for the country as a result of local shipping companies carrying cargo for local residents e.g., Food Commissioner, which otherwise might have had to be carried in foreign vessels and paid for in foreign exchange.

securities. Such investments were possible in 1974 because the gross external assets were maintained at a much higher level than the average for several preceding years. From around Rs. 650 million in August 1973, the gross external assets increased to over Rs. 1,000 million in February/March 1974 and after declining to Rs. 777 million at the end of July again increased to over Rs. 1,000 million in the later months. This consistently higher level of external assets gave the Central Bank sufficient leeway to derive a foreign income from such assets.

Outpayments on account of investment income consist both of remittances of profits abroad due on foreign capital invested in Sri Lanka and of interest payments on foreign loans. The latter category of outpayments has become very significant today on account of the state of our indebtedness abroad; interest payments have completely overshadowed the remittances on account of foreign private capital. From a level of Rs. 52 million in 1969, the profits/dividend remittances abroad have dwindled to Rs. 14 million in 1974 while interest payments on foreign debt in the same period have risen sharply from Rs. 68 million to Rs. 134 million. Thus, in 1974, interest payments accounted for 90 per cent of the outflow on this account.

(*d*) *Official Transfers*

Although grants from foreign governments valued at Rs. 254 million were much higher than in any year in the past, the sheer size of the current account deficit caused the relative importance of grants in financing Sri Lanka's balance of payments deficit to decline. The grant-financed part of the current account deficit declined from one third in each of the three years 1971 to 1973 to 21 per cent in 1974. The major part of grants (90 per cent) was in the form of food aid. Grants of wheat flour were valued at Rs. 123 million and rice Rs. 90 million. The principal donor country was the People's Republic of China. Other important donors were the Federal Republic of Germany, Australia and Canada.

III. Financing of deficit

The excess of payments for commodities and services from abroad over the income from exports of commodities and services, that is, the current account deficit, is normally financed by transactions in the non-monetary capital sector and through monetary movements. In Sri Lanka's context, commodity and project loans to the central government by foreign governments and import credit under short-term and suppliers' credit arrangements provide virtually the entirety of financing from the non-monetary capital sector. In keeping with historical trends, private capital has hardly provided any support to the balance of payments. Monetary movements comprise changes in the assets and liabilities of the Central Bank and commercial banks and in certain assets and liabilities of the central government which have monetary characteristics. This sector can provide finance for the current account deficit of the balance of payments either through a run down of assets, or through an increase of liabilities abroad (for example, purchases from the International Monetary Fund or borrowings from foreign banks) or a combination of both.

Since the very high current account deficit of 1969, close management of the balance of payments, which resulted in a steady and notable narrowing of the deficit, ensured that upto 1973 transactions in the non-monetary capital sector, i.e. long and short-term loans of the government and the private sector, not only compensated the deficit in full but also enabled the country to build up external assets. In 1971 the share of the current account deficit financed by net long-term capital was 186 per cent; in 1972 and 1973, 148 per cent and 120 per cent respectively. External assets steadily increased from Rs. 403 million in 1971 to Rs. 851 million in 1973. It is true that some of the types of financing, such as excessive resort to short-term credits and foreign loans of short maturity, were not desirable, but on the other hand it can be argued that some of these credits helped to build up assets. The overall financing picture in the four year period 1970 to 1973 therefore is that the current account deficit was financed wholly through transactions in the non-monetary capital sector. This also meant that the net foreign exchange assets position of the country, which is determined by monetary movements and defined as the difference between the foreign assets of the Central Bank, commercial banks and the government on one hand, and on the other the foreign liabilities of the Central Bank, commercial banks and the government*, improved from—Rs. 726 million in 1969 to +Rs. 36.7 million in December 1973[1].

These trends changed considerably in 1974 and was due mainly to the very large increase in the current account deficit arising from an increased import bill. Long-term loans, short-term and suppliers' credits (all net of repayments) together contributed to an inflow of Rs. 570 million during 1974. Although this is the highest ever recorded, still it left a gap of Rs. 350 million, which was financed through monetary movements. These took the form of increased indebtedness to the I.M.F., and increased recourse to credit from countries with which Sri Lanka has bilateral trade and payments pacts.

Assistance from the I.M.F. came very largely through the Oil Facility set up on 13 June, 1974. Under this Facility, the I.M.F. decided to make resources available to member countries to assist them to meet the adverse affect on their balance of payments of increases in the cost of oil imports. In drawing on this Facility, Sri Lanka along with others seeking assistance, undertook to (a) cooperate with the I.M.F. to find appropriate solutions for her balance of payments problems, and (b) in managing its international payments, to avoid adopting policies which would aggravate the balance of payments problems of other countries. Through two drawings during 1974, an aggregate amount of Rs. 271 million (SDR 34 million) was available for balance of payments support. As the I.M.F. itself had to borrow from oil exporting countries the funds to finance this Facility, the interest rate is 7 per cent per annum, which is higher than the 4 to 6 per cent per annum levied on other drawings. Other drawings from the I.M.F. came through the Standby Arrangement negotiated in the early part of the year.

The contribution of the bilateral trade and payments agreements for balance of payments financing is contained in the following figures:

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* Long-term loans, short-term and suppliers' credits to the government are excluded from this concept.

1 Minus sign indicates an excess of liabilities over assets; plus sign, an excess of assets over liabilities.

	1974		Rs Mn. Net
	1st Jan.	31st Dec.	Change
Amounts due to Sri Lanka from bilateral trading partners ..	97.1	26.6	−70.5
Amounts due from Sri Lanka to bilateral trading partners ..	42.4	209.3	−166.9
(of which China) ..	(33.8)	(158.5)	(−124.7)

Previous Annual Reports have underlined the undesirability of allowing large credit balances to be built up in Sri Lanka's favour (which is tantamount to Sri Lanka providing financial facilities) particularly when the two-way trade involves several commodities and the country has the option of running down these balances by increasing imports. The Sri Lanka/China pact, which involves mainly two commodities, rice imports and rubber exports, is in a special category and comments made in respect of other bilateral trade and payments pacts does not apply to this agreement. The balance in Sri Lanka/China account after being in Sri Lanka's favour in 1971/72 has since then turned against because the value of rice imports has outstripped the value of rubber exports. As shown in the figures above, this was a valuable source of financing the current account deficit.

Assistance from the oil exporting countries is a new source of balance of payments financing which was available in 1974. Directly this consisted of a cash loan of US $21 million (Rs. 137 million) from the monetary authority of Kuwait to the Central Bank repayable in 2 years. While the scale of support from this source can increase in importance in the next year or two as the number of participating countries increase, it must be realised that limits are bound to be reached in the capacity of these countries to give further credit. On the one hand with the rapid development programmes now under way in those countries, and on the other the operation of oil conservation measures and the search for additional sources of oil and substitutes by consuming countries is bound to reduce the amount of surplus oil funds. The importance of keeping the balance of payments deficit to proportions dictated by available resources thus cannot be over-emphasised.

As a result of these monetary movements financing the foreign exchange gap the net foreign exchange assets position fell from +Rs. 36.7 million at the beginning of the year 1974 to—Rs. 279.4 million at the end of the year—an adverse turn round of Rs. 316.3 million.

B. The Exchange Rate System

Since July 1972, the Sri Lanka Rupee has been pegged to the Pound Sterling at the rate of Sri Lanka Rupees 15.60=1 Pound Sterling and the exchange rate system is based on this official rate for the Pound Sterling. Exchange rates for other currencies important for Sri Lanka's trade, including the US dollar, are determined by the Central Bank from time to time, on the basis of London market rates for those currencies. Rates for other foreign currencies are determined by commercial banks, also on the basis of London market rates as quoted by the Bank of England.

TABLE II (H) 5

Modes of Financing the External Resource Gap 1973—1974

	1973		1974(a)	
	Rs. Mn.	% Share	Rs. Mn.	% Share
Resource Gap	1,523		— 2·516	
Financing ..	1,523	100·0	+ 2,516	100·0
1. External Assets ..	—125	8·2	— 38	— 1·5
2. Borrowings from abroad ..	—	—	16	0·6
3. I M.F. Drawings ..	137	9·0	106	4·2
4. Oil. Facility drawings ..	—	—	271	10·8
5. Bilateral Trade Balances ..	35	2·3	167	6·6
6. Short—term Trade Credits ..	781	51·3	836	33·2
7. Supplier's Credits ..	240	15·8	429	17·1
8. Commodity Aid ..	210	13·8	328	13·0
9. Project Aid ..	125	8·2	103	4·1
10. Grants ..	83	5·4	254	10·1
11. Private Capital ..	6	0·4	12	0·5
12. Other ..	14	0·9	16	0·6
13. Special Drawing Rights ..	—	—	—	—
14. Errors and Omissions ..	17	1·1	16	0·6

(a) Provisional

Source: Central Bank of Ceylon

During 1974, the Sri Lanka Rupee appreciated against most currencies including the US dollar. The change in the rate at the end of the year compared with the level at the beginning of the year was most marked in the case of the Australian Dollar, Japanese Yen, New Zealand Dollar and the Italian Lire. Compared with the mild depreciation of the Sri Lanka rupee vis-a-vis other foreign currencies in the previous year, the exchange rate in 1974 showed an overall appreciation of about 3% against other foreign currencies.

Not all foreign exchange transactions are carried out at this official rate of exchange. Since the introduction of the Foreign Exchange Entitlement Certificate (FEEC) Scheme in May 1968, certain export products and an increasing variety of import commodities as well as invisible transactions have been diverted to another exchange market where transactions currently take place at 65% above the official rate. On the receipts side, other than the exports of tea, rubber, coconut (oil, desiccated coconut and copra), all other export commodities, and invisible transactions excluding diplomatic accounts, qualified for the premium rate of exchange. On the payments side, except imports of rice, wheat flour, fertilizer, and some miscellaneous

TABLE II (H) 6

Sri Lanka's Foreign Exchange Transactions

1973 and 1974*

Rs. Million

	1973				1974*			
	Par Value	Official rate	Certificate rate	Total	Par Value	Official rate	Certificate rate	Total
Current Receipts		1,843	1,021	2,864		2,809	1,320	4,129
Exports		1,694	652	2,346		2,492	884	3,376
Services[1]		149	369	518		317	436	753
Current Payment		— 920	— 2,105	—3,025		—2,085	—2,942	—5,027
Imports		— 875	— 1,769	—2,644		—2,035	—2,568	—4,603
Services[1]		— 45	— 336	—381		— 50	— 374	— 424
Capital Accounts		1,068	— 907	161		2,051	—1,152	899
Non-monetary Capital		1,402	— 924	478		1,689	1,168	521
Receipts		1,402	6	1,408		1,689	12	1,701
Payments		—	930	930		—	1,180	1,180
Monetary Capital	—19	— 315	—	—334	220	142	—	362
Receipts	123	23	—	146	284	239	—	523
Payments	106	338	—	444	120	97	—	217
Difference in valuation (Net)	— 36	—	—	—36	56	—	—	56
Other(E. &. O. E.	—	—	17	17	—	—	16	16

1. Including private transfers and official transfers (grants) *Source:* Central Bank of Ceylon

* Provisional

items (for full list see below*) and, diplomatic accounts and remittances of Provident Fund benefits from among invisible items, all other transactions were at the premium rate of exchange. The foreign exchange transactions in 1973 and 1974 are shown in Table II (H) 6.

C. External Assets

TABLE II (H) 7

Gross External Assets of Sri Lanka

Rs. Million

	Dec. 1972	Dec. 1973	Dec. 1974	Change 1972/1973	Change 1973/1974
Government ..	53.7	3·3	0·5	—50.4	—2.8
Government Agencies and Institutions ..	67.3	70.7	74.3	+3.4	+3.6
Central Bank ..	285.4	480.5	420·1	+195·1	—60.4
Commercial Banks ..	320·3	296.7	393.9	—23.6	+97.2
Total	726.7	851.2	888·8	+124.5	+37·6

Source: Central Bank of Ceylon

From year-end to year-end for the fifth successive year the gross external assets of Sri Lanka increased and at Rs. 889 million at end-December 1974 showed an improvement of Rs. 38 million over the level at the end of the previous year. This improvement occurred despite an unprecedently large deficit in the current account of the balance of payments and this was due to the build-up of external liabilities on a very substantial scale.

Although the Central Bank was the major holder of external assets, commercial bank holdings also rose markedly due to the increase in the value of export bills discounted by commercial banks. These amounted to Rs. 202 million in 1973 and increased to Rs. 303.8 million in 1974. Exports bills accounted for over 75 per cent of the value of external assets held by commercial banks. This increase has taken place because of higher prices for exports and not on account of relaxation in the terms of credit for exports.

* (*a*) **Food Imports**

Rice, Wheat Flour, Wheat grain, infants milk food, dried fish, masoor dhal(including whole brown lentils and split red lentils), corriander and cummin seed.

(*b*) **Other Imports**

Fertilizers, Western drugs, books, periodicals, magazines, news papers, maps and charts, two-wheeled tractors, implements and spares thereof, hearing aids and parts thereof, artificial dentures, limbs and eyes and all milling copra.

(*c*) Raw materials, packing materials, machinery, equipment and spares required for the manufacture or processing of the following—

(i) Fertilizer;
(ii) Wheat Flour;
(iii) Infants milkfood;
(iv) Western drugs.

(*d*) Imports of currency notes and coins by the Central Bank of Ceylon and Commercial Banks operating in Sri Lanka.

(*e*) Imports financed under the Asian Development Bank loans for tea factory modernisation, but subject to a licence fee of 20%.

(*f*) Imports under I. B. R. D. Loan for the Maskeli Oya Project Stage II.

D. External Debt* and Debt Servicing

The very large and continuing balance of payments deficits and the inadequacy of reserves to finance them has put the main financing burden on foreign credits as a result of which external liabilities have increased very sharply. An inevitable outcome of the progressive increase in the external debt over several years has been a corresponding increase in the service payments on the debt. Repayment of the principal and interest are a first charge on the export earnings.

Long-term capital is the most appropriate form of finance for covering deficits as the annual service commitments on such capital are generally mild. However, as long-term Capital inflows have been meagre and therefore insufficient to bridge the deficits other forms of borrowing such as drawings from the I.M.F., suppliers' credits, and borrowings from foreign banks had to be used despite their higher servicing costs. By the beginning of the 1970s, service payments on the foreign debt absorbed about 20 percent of the country's foreign exchange earnings from abroad.

Service payments on Sri Lanka's external debt over the last five years are given in Table in II (H) 8. In 1974 total debt service payments amounted to Rs. 611 million comprising Rs· 549 million in amortisation payments (1973—Rs. 521 million) and Rs. 134 million in interest payments (1973—Rs. 108 million). Amortisation payments have not shown a sharp increase, but interest payments have risen from Rs. 68 million in 1969 to Rs. 134 million in 1974. The latter was the result not only of the ever increasing level of borrowings, but the increasing use of short-term credits, which carry higher interest rates, and in view of the rising interest rates in world money markets.

The debt service ratio, which is the proportion of foreign exchange earnings on current account absorbed by the external service payments, is commonly used to assess a country's debt burden. Generally, a rising ratio would indicate an increasing burden and greater short-term rigidity in the balance of payments, while a falling ratio will have the opposite effect. In Sri Lanka's case the debt service ratio after reaching 23.0 per cent in 1973 fell back in 1974 to 17.9 percent. That this happened when total service payment has been higher than ever, is entirely because of the substantially higher earnings in 1974. For the servicing problem to be manageable, as implied by a lowering of the debt service ratio, continuing gains on the earnings front, will be needed.

* Data in this section may differ from those provided in the Section on Public Finance due to the inclusion of external indebtedness of financial institutions, such as the Central Bank and the private sector in this note.

TABLE II (H) 8

External Debt *Outstanding and Service Payments 1970—1974

Rs. million

	1970	1971	1972	1973+	1974 X
Long Term Debt ..	1596.4	1919.0	2336.8	2687.4	2926.4
Suppliers' Credits ..	—	74.6	94.0	329.1	517.8
I. M. F. Drawings ..	489.8	448.2	466.1	463.5	627.7
Bank Borrowings ..	411.5	333.8	352.2	245.2	261.9
Total	2497.7	2775.6	3249.1	3725.2	4333.8
1. Debt Service Payment ..	453.4	491.6	480.2	629.2	683.7
(a) Amortization ..	353.7	387.1	378.3	520.8	549.3
(b) Interest	99.7	104.5	101.9	108.4	134.4
2. Earnings on exports of goods and services	2253.3	2244.2	2205.9	2733.3	3820.3
3. Debt Service ratio (1 as a per cent of 2)	20.1	21.9	21.8	23.0	17.9

* Excludes short-term trade credits

\+ Revised

X Provisional

E. The Convertible Rupee Account Scheme

The Convertible Rupee Account Scheme, which supplemented the exchange and fiscal incentives to promote exports of a non-traditional nature, continued to be in operation throughout 1974 with certain modifications. Since August 1974 the transfer of funds from one account to another has been permitted under certain conditions. Hitherto, the Convertible Rupee Account facility was limited only to the immediate exporter, and the amendment was aimed at resolving an operational inequity in the scheme. Since the amendment took effect exporters have been able to pass on the benefit to the actual producer. With the Budget of 1974 certain changes were made in the rates at which credits are allowed to convertible rupee accounts. Gem exports, exports and sale to tourists by individuals of original paintings, sculpture and other works of art, publication abroad of scientific and literary works by individuals, and professional and consultative services rendered by individuals which earlier qualified for a rate of 25 per cent now became eligible for 20 per cent. The entitlement in respect of other earnings, which previously qualified for this facility at 3 per cent, was increased to 5 per cent.

The number of convertible rupee accounts with the authorised dealers increased by 535 during 1974 and stood at 1244 at the end of the year. Credits to these accounts during the course of the year totalled Rs. 69.4 million, while the cumulative total of credits as at December 31st 1974 amounted to Rs. 123.6 million. On the other hand, total debits during the year totalled Rs. 54.9 million and cumulative total of debits Rs 77.5 million.

In 1974 an important development in the transactions in the convertible rupee accounts was an increase in the rate of utilization of funds lying to the credit of these accounts. Upto end-December 1973 the amount utilized was only Rs. 22.6 million

TABLE II H 9

Convertible Rupee Accounts Scheme

(Rs. Million)

Period	CREDITS						DEBITS			
	No of Accounts	Gem Exports	Other Exports	Tourism	Other	Total	Travel	Imports	Local Expenses	Total
End Dec. 1973	709	46.490	6.786	0.874	0.051	54.202	3.037	19.143	0.451	22.630
1974	535	47.249	19.315	2.227	0.621	69.412	6.463	45.110	3.295	54.868
End Dec. 1974	1244	93.739	26.101	3.101	0.672	123.614	9.500	64.253	3.746	77.498

Source: Central Bank of Ceylon

out of a cumulative total of Rs. 54.2 — an utilization rate of 42 per cent. By the end of 1974 this rate had increased to 63 per cent. If the transactions in 1974 only are considered, the utilization rate was as much as 79 per cent,

As in the previous year, gem exports have been the mainstay of the convertible rupee fund in 1974 accounting for Rs. 47.2 million. However, their relative importance had declined from 86 per cent of total credits in the previous year to 70 per cent in 1974. Partly this has been due to the lower overall export earnings from the sale of gems and partly because other items involved in the scheme enjoyed better prospects. The rate changes proposed in the Budget, downwards for gems and upwards for others, are likely to further reduce the bias towards more earnings from gems being credited to these accounts.

As in the previous period, the larger share of debits to convertible accounts in 1974 has been for imports. As shown in table II (H) 9 of the total debits amounting to Rs. 54.9 million during the year, Rs. 45.1 million (82 per cent) has been for imports while Rs. 6.5 million and Rs. 3.3 million were in respect of foreign travel and local expenses respectively. Based on data on import licences issued, the bulk of payments for imports has been for trade quota items (48 per cent) and industrial raw materials (28 per cent). Convertible rupees utilized for the importation of motor vehicles and other direct-user items amounted to 12 per cent and 11 per cent respectively of the total licences issued. It is thus seen that the bulk of the convertible rupee funds arising from the scheme has been used to promote industry rather than to cater directly to personal consumption.