PART I

ECONOMIC PERFORMANCE, PROBLEMS AND POLICIES IN 1978

INTRODUCTION

In 1978, the Sri Lanka economy registered an impressive growth rate of 8·2 per cent. This was almost twice the growth rate of 4·4 per cent achieved last year; and almost equals the growth rate of 8·4 per cent in 1968, the highest recorded by the country in recent times; and was more than twice the average annual growth during the last decade. Further, unlike in previous years when growth was confined to a few sectors, while some sectors either declined or stagnated, the growth impulses were evident on a broader front in 1978.

Sri Lanka's terms of trade which improved successively in two preceding years, declined marginally in 1978, primarily on account of a fall in tea prices and an increase in import prices. Exports were moderately higher, but imports were substantially higher than in 1977. Thus, the modest trade surplus of 1977 turned, as anticipated, into a substantial deficit in 1978. Consequently, the current account of the balance of payments too turned from a surplus to a deficit. However, substantial capital inflows, together with resources from the International Monetary Fund, went on to create a favourable overall balance in Sri Lanka's payments, augmenting the external assets for the third year in succession, to a level that would normally be adequate to meet four months' imports projected for 1979.

The expansionary effect of the growth of external assets, however, was largely moderated by a contraction induced by the government sector during the year. This development, combined with the stringent monetary policies that were continued during 1978, helped to contain the expansion in money supply to 11 per cent, in contrast to increases of 29 and 35 per cent in the two previous years. These factors, along with the substantial growth in output, helped to contain inflationary pressures in the economy at a level lower than in the previous year. Real wages outside the public sector grew in 1978. Also, the revival of economic activity seems to have made some dent in the growing problem of unemployment.

The impressive revival of the economy and the attendant developments in 1978 could be traced back to the economic reforms initiated in 1977. Fundamental to the new economic policy was the adoption of a realistic exchange rate for the Sri Lanka Rupee, with a view to reducing the price distortions arising from the previous attempts to maintain an overvalued currency by means of stringent trade and payments controls. The then prevailing multiple exchange rate system was unified and the Rupee was allowed to float. This enabled the relaxing of most trade and payments controls; and a shift from quantitative restrictions to tariffs as a means of protecting domestic enterprise.

The resulting trade liberalization was expected to revive domestic industry by freer flows of raw materials, spares and machinery, by higher capacity utilization, and by greater competition, either among local enterprises or from imports, subject to reasonably protective tariffs. On the export front the new exchange rate was expected to provide better export incentives generally, while inducing the primarily import-substituting industries to expand outwards to export markets. In domestic agriculture, the new exchange rate was expected to eliminate price distortions and provide greater incentives for increased production. Generally, the private sector was to be encouraged and the preferential treatment of the public sector was to be ended. Monopolies, in public or private sector, were to be curtailed. With greater competition, price and other domestic controls were to be eliminated.

Foreign investment was to be encouraged, especially with a view to acquisition of higher technology and development of new export markets. Attractive incentives were offered to foreign entrepreneurs who invest in export oriented industries to be located in "Export Processing Zones" which were to be established in a specified area under the Greater Colombo Economic Commission. Inflationary pressures were to be contained by prudent monetary and fiscal management and by fostering competition rather than by price and other controls. A greater volume of resources was to be mobilized for development by offering positive real interest rates to savers. Inflationary pressures in the short-run were to be contained by a sharp acceleration of short-term interest rates while the long-term rates were generally left unaffected. Foreign banks were to be encouraged primarily as a means of mobilizing more resources for development.

In the fiscal field, budgets were to generate adequate surpluses and resort to expansionary financing was to be avoided. A transfer of resources from consumption to investment was envisaged by limiting general consumer subsidies to a target group of the most needy. The tax system was to be re-organized to restore incentives to save and invest. The investment climate was to be improved by ensuring political and economic stability. The current account deficits that were likely to emerge in the balance of payments during the medium term period of economic transformation, as a result of import liberalization and short-term rigidities in export growth, were to be met by a greater mobilization of external assistance. Generally speaking, these policies envisaged a sweeping departure from a tightly controlled, inward looking, welfare oriented economic strategy to a more liberalized, outward looking and growth oriented one.

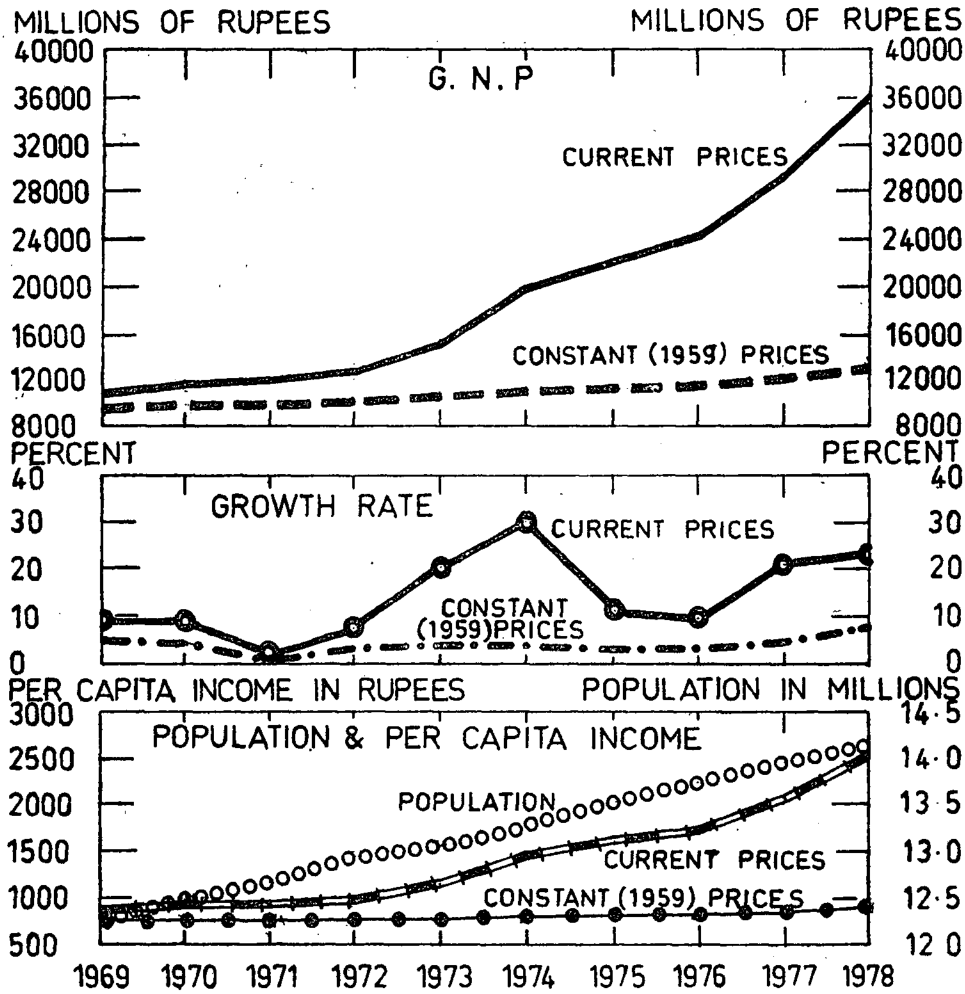
The Gross National Product at current prices rose by 24 per cent in 1978. When deflated for price increases, the real growth in the national product was 8·2 per cent. Allowing for the population increase of 1·7 per cent, the real product per capita grew by 6·4 per cent, which is significantly higher than the growth of 2·6 per cent in the previous year. The national product per capita at current market prices rose from Rs. 2095 in 1977 to Rs. 2548 in 1978, an increase of 22 per cent.

The agriculture sector which accounted for one half of the economic growth in 1977, was responsible for only 17 per cent of the increase in the Gross National Product in 1978. Indicating the growth of several sectors on a broad front in 1978, construction accounted for 16 per cent, trade for 14 per cent, industry for 13 per cent, mining and quarrying for 11 per cent and "other services", for 10 per cent.

GROSS NATIONAL PRODUCT

AT CURRENT FACTOR COST PRICES

ANNUALLY



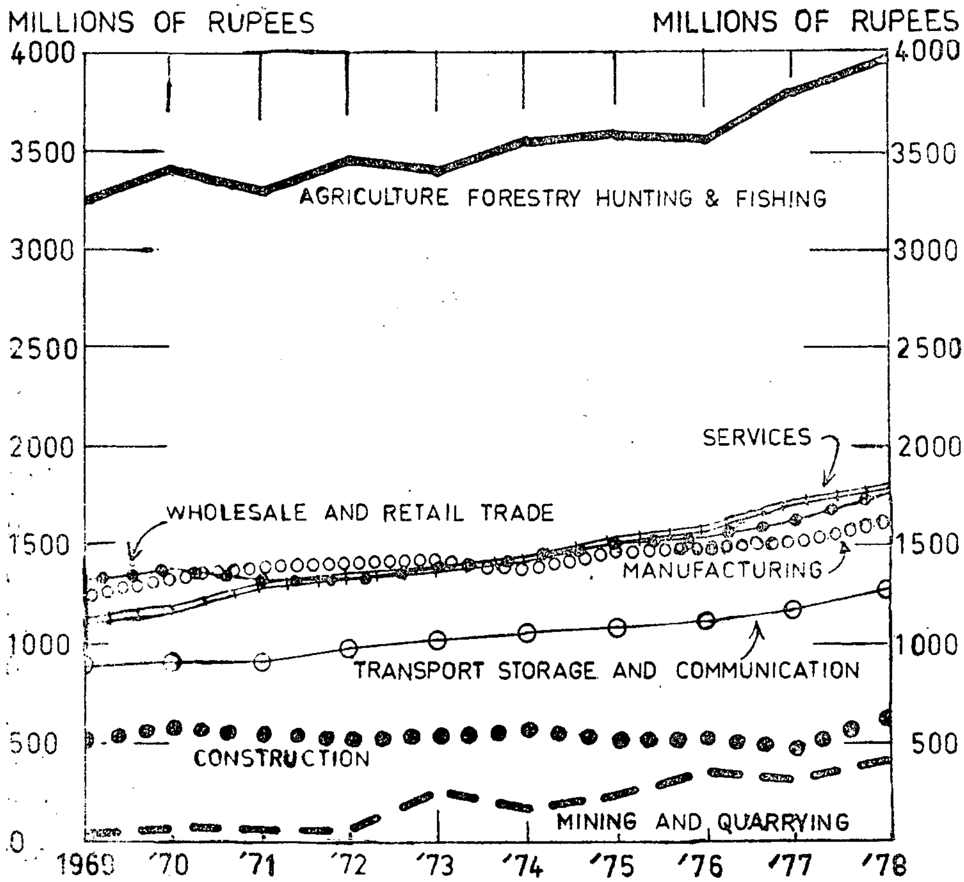
Dept. of Economic Research

Source: Central Bank of Ceylon

GROSS DOMESTIC PRODUCT BY INDUSTRIAL ORIGIN

AT CURRENT FACTOR COST PRICES

ANNUALLY



Dept. of Economic Research

Source: Central Bank of Ceylon

The notable growth of all these sectors could be attributed primarily to the new economic policies of 1977. The growth of trade and industry was aided largely by the import liberalization. Growth in agriculture was helped by improved producer margins in rubber and coconut arising partly from the new exchange rate, and by the better prices for paddy. The expansion of construction, mining and quarrying was largely the result of the construction boom that followed the improved investment climate as well as the decontrol of the trade system.

The growth of the agriculture sector slowed down from 7 per cent in 1977 to 4 per cent in 1978. Paddy production which rose by 34 per cent last year, progressed further by 13 per cent to an all-time high of 91 million bushels in 1978, permitting a sharp reduction in rice imports. The Maha and Yala season peaks of 1977 were exceeded by 12 and 13 per cent, respectively largely on account of favourable weather, increased fertilizer use, more credit and a higher guaranteed price. Tea production which recovered last year declined by 5 per cent. Rubber production which dropped last year by 4 per cent rose by 7 per cent in a climate of buoyant prices. Coconut production too rose by 21 per cent, on account of more favourable weather in the past year which induced a greater use of fertilizer. Traditional minor export crops fared unevenly, while subsidiary food crops declined. Fishery appears to have progressed somewhat while the livestock industry suffered a setback. On the whole, 1978 was an uneven year for agriculture.

As will be commented upon later in more detail, the uneven performance of export agriculture, particularly the set back suffered by tea, were matters of grave concern. Rejuvenation of this sector should be given high priority in the new economic policies. A greater dynamism in this field is essential to generate and harness resources to sustain the far reaching economic reforms, including trade liberalization, during the coming period of economic transformation, and to service repayments of debts contracted now, in the not so distant future. This sector is also critically important in generating adequate revenue to maintain public investment at a high level. Furthermore, a major part of the export-led growth impulse could be expected from export agriculture, whose potential is yet considerable. Hence, adequacy of producer margins, especially in relation to export taxation, trends in cost of production, and the need for continuation of market controls, are matters that deserve close examination.

In the field of domestic agriculture, the perennial conflict between the need to assure remunerative margins to the producer while ensuring what were deemed to be "reasonable" prices to the consumer, continued through 1978. It appears that the continued availability of heavily subsidized flour could dampen greater import substitution in subsidiary food crops. Also, if the operation of "buffer stock" schemes, meant essentially to even out seasonal fluctuations in prices, are permitted to overly depress producer prices to uneconomic levels, a similar adverse impact on domestic production could occur. Needless to say, there has to be a trade-off between the conflicting requirements of consumers and producers.

The stagnant industry of Sri Lanka received a boost by the import liberalization. Value of output in the factory and small industry sector has been estimated to have grown by 11 per cent in 1978, the private sector growing marginally higher than the public sector. Basic metals, Textiles, Non-Metallic Minerals, Paper and Chemicals were the main growth sectors. In textiles, the growth of the larger firms appears to have more than compensated a decline in the smaller, but this could have had adverse effects on employment in this sector. More than the import liberalization per se it appears that the pricing policy on textiles, where an attempt is made to keep prices of popular textiles low by government imports at lower tariffs, has caused this problem. Some industries such as food, metal product and machinery appeared to be unable to compete with imports, despite substantial tariff protection Therefore, time is opportune now for a full reappraisal of industrial policy. There is no economic sense in continuously protecting basically inefficient industries. An export-oriented industrial policy envisaged now would require the active fostering of a highly efficient and internationally competitive industry. On the other hand, there was a dynamic response by the public sector industries at the outset, but this appears to have waned somewhat with the passage of time. It appears that some public industries yet continue to enjoy monopoly power, as in Cement and Ceramics, sometimes even in trading activities, as in the case of import of caustic soda by the Paranthan Chemicals Corporation. The need for continuance of such monopolies may be reviewed, with a view to assessing any gains that could result from increased competition. Also, there appears to be a need for greater autonomy in pricing and production policies in public sector industries.

The transport and communications sector in the country has clearly lagged behind in recent times. In nationalized public road passenger transport, the operated mileage has been 18 per cent lower than the required mileage, and despite an increase in bus fares in 1978, the financial position of the composite organization in charge, does not appear to have improved further. A decentralization of the organization does not seem to have helped to improve the services. The government has contemplated the supplementing of existing services by private transport services in certain selected sub-urban routes. But inadequacy of service has been found mostly in the case of urban commuter traffic, where the service has not kept up to meet a rapidly growing demand. The nationalized service has not been able to meet the growing demand largely because of inadequate investment, due to continuing operational deficits arising from the low fares system that has been operative. On the other hand, available data suggest the continuous deterioration of the railway service. In the context of rising oil prices, and the growing demand for public transport arising from increased economic activity, a much greater investment in public transport, a rationalization of the fares structure, and better management are of vital importance. In road haulage, however, the import liberalization resulted in the registration of 4,874 lorries and vans in 1978, which was more than twice the total addition to the fleet during the 5 years ending 1976. This has cleared a vast pent up demand; and increasing competition appears to have induced a drop in most transport charges by about 10 to 20 per cent in 1978. The national telecommunications system has got antiquated owing to inadequate past investment. A speedy transport and communications system is a pre-requisite for attracting foreign investment and achieving high rates of economic growth.

As anticipated, the trade and payments position of Sri Lanka was adverse in 1978, largely on account of a 23 per cent growth in imports and a marginal rise in exports, resulting in a trade deficit of Rs. 2,143 million (SDR 133 million). Surplus on services declined on account of higher expenditures on foreign travel for business, education, export promotion and other purposes, but net transfers showed an appreciable rise because of a sharp increase in remittances by Sri Lankans working abroad. Thus, the current account of the balance of payments showed a deficit of Rs. 782 million (SDR 64 million) which compares with the surplus of Rs. 1,266 million (SDR 116 million) last year. However, a large increase in net capital inflows – from Rs. 563 million (SDR 54 million) to Rs. 2,640 million (SDR 135 million) – more than offset the current deficit ; and went on to augment external assets by Rs. 1,904 million (SDR 65 million) at the end of the year.

As in the previous year, external banking assets rose, owing to the ovreall surplus in the balance of payments; but the expansionary impact of this development on the economy was considerably moderated by the contractionary impact of the government sector. As a result, the increase in money supply during 1978 was kept down to a relatively tolerable level of 11 per cent, which was in sharp contrast to increases of 29 and 35 per cent in the two previous years. The stringent monetary policies involving restraint on credit expansion to the private sector and high short-term interest rates were continued during 1978 and were reinforced by a ceiling on lending to public corporations. Thus, had it not been for the monetary and fiscal restraint that was enforced during 1978, restoration of economic stability in the country, which is essential for economic growth, would not have been realized. There were some complaints of the high cost of credit, but the monetary policy adopted should be viewed as a short-term anti-inflationary measure aimed at restoring monetary stability after two successive years of rapid expansion. It is essential for an expanding economy to pay a positive real rate of interest on savings. In other words, if adequate resources for development are to be generated, savers should be paid a return (which is the rate of interest) which is higher than the expected (or at least, the current) rate of inflation. With inflation running at around 15 per cent, a return to the cheap money policies of yesteryear will be clearly counter-productive. The very high demand for credit in 1978 indicated that borrowers have not been baulked by the current level of interest rates. Of course, it is possible that the long-term investor could be discouraged somewhat by high interest rates. It was for this reason that the rates of the long-term lending institutions were left virtually unaffected by the interest rate reform of 1977. It appears that there was an inadequacy of long-term capital. The new National Development Bank, which will commence operations in 1979, is expected to fill this vacuum, largely.

The 1977 economic reforms led to a substantial rise in the revenue and expenditure of the Government. The anticipated surplus, however, could not be generated, there being a deficit of Rs. 701 million in the current account. Fiscal operations in 1978 revealed an expansionary impact of Rs.173 million, which was quite contrary to the picture presented by the monetary and banking data, of a contractionary impact of Rs. 1,500 million. This was largely due to certain financial transfers effected at the end of the year and an unusually high float of uncleared cheques. When the necessary adjustments are made, the budgetary operations during 1978 would show a contractionary impact of Rs. 893 million. The under-utilization of capital votes declined from 27 per cent in 1977 to 16 per cent in 1978. The contemplated acceleration of government activity from 1979 onwards would necessitate an even better utilization of capital votes.

As mentioned last year, 1977 was a clear watershed in the economic history of Sri Lanka, when the country turned away from a predominantly inward looking, tightly controlled and welfare oriented strategy to one which primarily emphasized export growth, competition and higher capital investment for economic growth and employment generation. The year 1978 was the first full year under the new economic regime, and several problems in adjusting from a controlled regime to a liberalized one were evident. But, the spontaneous and immediate response of the economy to the new economic policy in achieving a high growth rate was the most encouraging feature of 1978. The slow overall growth of exports was partly due to the setback suffered by the tea industry and partly to the normal time lags in the response of exports to the new incentives, Nevertheless, in the traditional sector where price incentives have been reduced to siphon off windfall gains, a review of policies may be necessary to induce a quicker positive response, especially in tea, coconut and minor export crops.

It was a major achievement to contain inflation, after the exchange reform, the withdrawal of some subsidized food rationing, the grant of wage increases and the general increase in prices of imports following inflation all over the world. The tight monetary policy, fiscal discipline, competition induced by liberalization, higher imports and the bumper paddy harvest were helpful in moderating the pressure on prices. A careful watch will have to be kept on the prices front in the future, if Sri Lanka is not to be priced out of world markets.

Clearly, the rapid spurt of the economy in 1978 was the immediate response of a hitherto long stagnant economy to the relaxation of controls and the restoration of price incentives. In the immediate future and in the long-run, the maintenance of such a growth momentum would require a higher level of savings and investment and further policy decisions aimed at fostering economic growth. A difficult trade-off between the interests of consumers and producers would be required. Remaining monopolistic powers and non-productive controls would have to be whittled down. An acceptable balance between growth and equity will have to be worked out. The economy, in its performance in 1978, has clearly shown that, given an appropriate policy climate, it has the potential of moving on to a path of sustained economic development.