ECONOMIC PERFORMANCE, PROBLEMS AND POLICIES IN 1984

INTRODUCTION

In 1984, Sri Lanka's real Gross Domestic Product (GDP) is estimated to have increased by 5.1 per cent compared with 5.0 per cent in the previous year. The Gross National Product (GNP) at constant (1982) factor cost prices recorded an increase of 5.3 per cent improving substantially over the growth rate of 4.1 per cent registered in 1983. This improvement was due to the net outflow abroad of factor income in 1984 remaining more or less at the same magnitude as in 1983 while GDP increased.

TABLE 1.1

National Income Statistics 1982 - 1984

Item	Amount (Rs. Million)			Growth Rate (%)	
	1982 (*a*)	1983 (*a*)	1984 (*a*)	1983	1984
1. G.D.P. at Current Factor Cost Prices ..	93,194	111,976	138,173	20·2	23·4
2. G.D.P. at Constant (1982) Factor Cost Prices ..	93,194	97,899	102,906	5·0	5·1
3. G.N.P. at Current Factor Cost Prices ..	91,235	108,762	134,817	19·2	24·0
4. G.N.P. at Constant (1982) Factor Cost Prices	91,235	94,963	99,949	4·1	5·3
5. Mid Year Population ('000) ..	15,189	15,416	15,599	1·5	1·2
6. G.N.P. per capita (Rs.)					
i. At Current Prices ..	6,007	7,055	8,643	17·4	22·5
ii. At Constant Prices ..	6,007	6,160	6,407	2·5	4·0

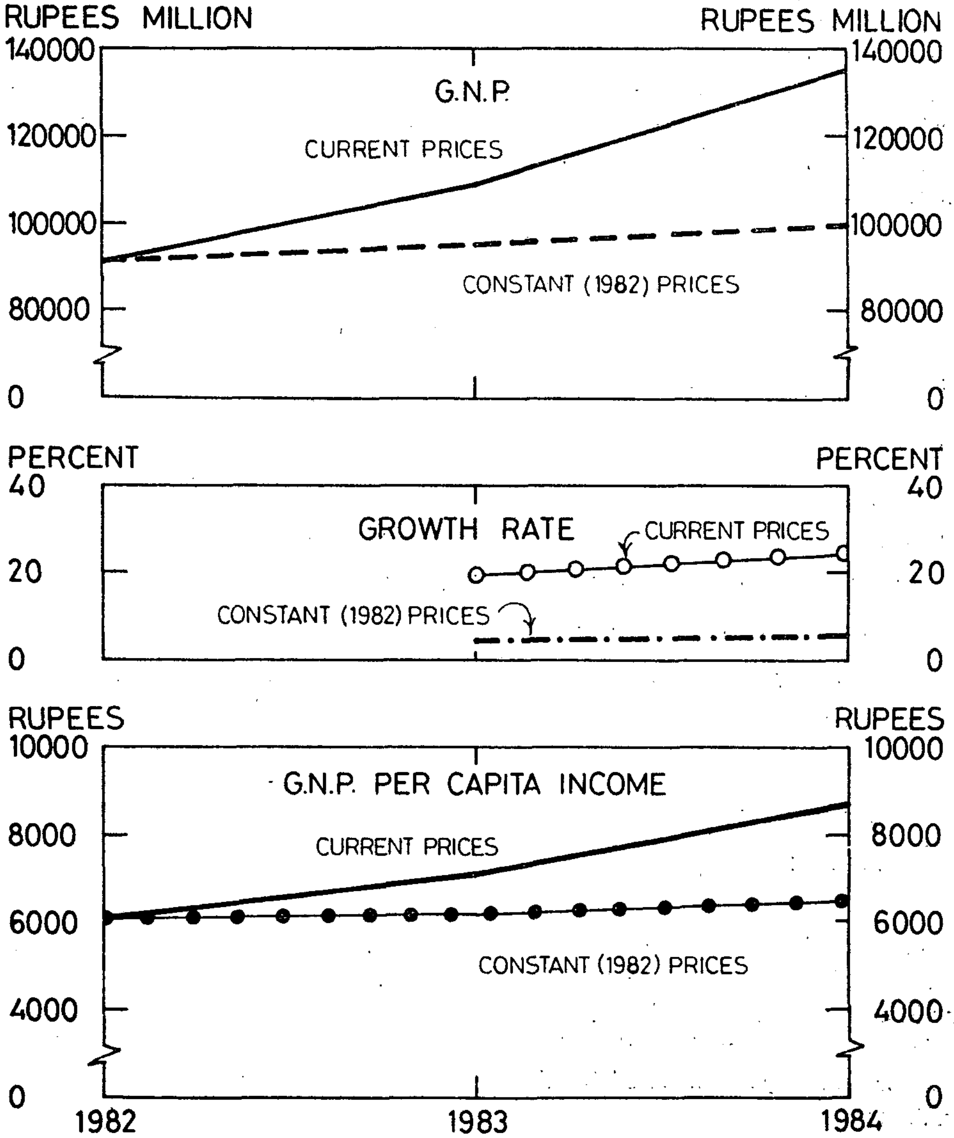
(*a*) Provisional

Source : Central Bank of Ceylon.

Measured at current factor cost prices, GNP in 1984 is estimated at Rs. 134.8 billion, indicating a 24 per cent increase over 1983. When account is taken of the increase in real GNP, the implicit GNP deflator in 1984 is estimated at 17 per cent which was marginally higher than the 16 per cent change recorded in 1983. This increase was largely influenced by high prices of agricultural exports, mainly tea and rubber.

According to estimates made by the Registrar General's Department, Sri Lanka's population rose by 1.2 per cent in 1984. Allowing for this increase in population, real per capita income increased by 4 per cent compared with 2.5 per cent in 1983. Per capita GNP at current prices is estimated at Rs. 8,643 (US $ 340 at the average rate of exchange for 1984).

GROSS NATIONAL PRODUCT



An analysis of sectoral composition of GDP growth in 1984 shows that the increase of 5.1 per cent in real GDP was largely the combined effect of the improved performance in manufacturing and services. Apart from the declines in coconut and paddy in the agricultural sector there was a more balanced growth in all other sectors compared to 1983 when income generation was mainly confined to agriculture and services. The growth in value added in manufacturing at 12.3 per cent in 1984 was substantially higher than in the previous year. Meanwhile, the services sector which maintained a relatively high rate of growth in the last few years grew by 5.8 per cent in 1984. Growth in the agricultural sector slowed down considerably to 2.2 per cent. There was also a small deceleration in construction activity.

TABLE 1·2

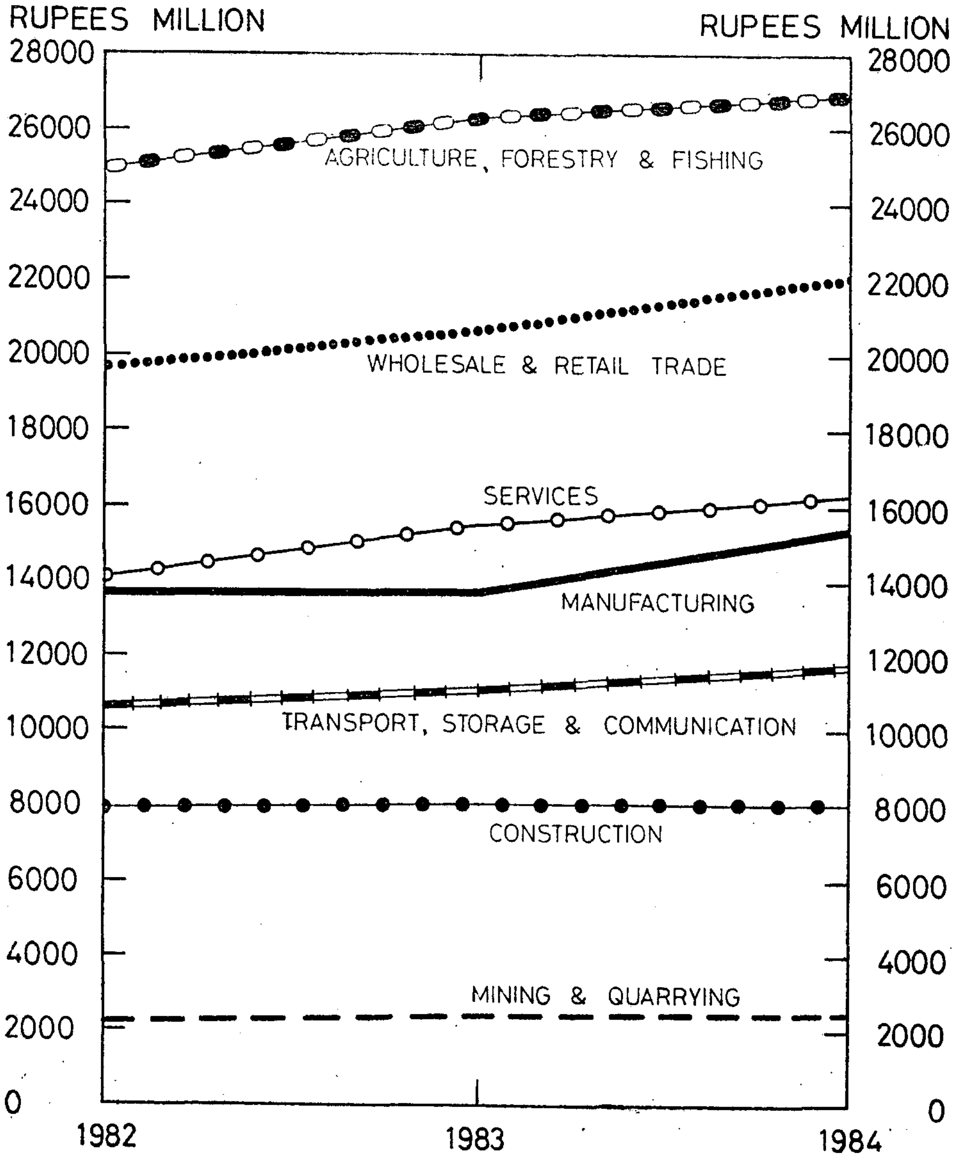
Composition and Growth of GNP 1982 – 1984 at Constant (1982) Factor Cost Prices

Sector	Amount (Rs. Mn.)			Growth Rate	
	1982 *(a)*	1983 *(a)*	1984 *(a)*	1983	1984
1. Agriculture, Forestry and Fishing of which:	24,964	26,294	26,866	5·3	2·2
1·1 Tea	2,418	2,309	2,681	- 4·5	16·1
1·2 Rubber	770	865	878	12·3	1·5
1·3 Coconut	3,263	2,992	2,564	- 8·3	- 14·3
1·4 Paddy	5,484	6,318	6,166	15·2	- 2·4
1·5 Other (including subsidiary food crops, forestry and fishing)	13,029	13,810	14,577	6·0	5·6
2. Mining & Quarrying	2,238	2,413	2,449	7·8	1·5
3. Manufacturing	13,601	13,710	15,390	0·8	12·3
3·1 Tree Crop Processing	2,846	2,715	2,983	- 4·6	9·9
3·2 Other	10,755	10,995	12,407	2·2	12·8
4. Construction	7,959	8,039	8,030	1·0	- 0·1
5. Services	44,432	47,443	50,171	6·8	5·8
6. G.D.P.	93,194	97,899	102,906	5·0	5·1
7. Net Factor Income from Abroad	- 1,959	- 2,936	- 2,957	—	—
8. G.N.P.	91,235	94,963	99,949	4·1	5·3

(a) Provisional. *Source:* Central Bank of Ceylon.

The performance of the various sub-sectors in GDP has not shown any consistent growth pattern over the last few years. This has been reflected in the changing sectoral origins of GDP growth. The poor performance of the agricultural sector in 1984 was largely the result of negative growth in the paddy and coconut sub-sectors. Value added in paddy which recorded the highest ever rate of growth in 1983 declined by two per cent due to flood damage to the Maha 1983-84 paddy crop. Coconut production was also affected by the adverse weather conditions in the previous year resulting in a severe decline in value added for the second consecutive year. Rubber showed a marginal growth of 1.5 per cent. The adverse impact of the decline in paddy and coconut was more than offset by the 16 per cent increase in value added in tea. Growth in other agriculture continued to be high. Manufacturing was a leading growth sector in 1984, recording a vastly improved performance. Increased tea production during the year contributed largely to the growth of 10 per cent in value added in tree crop processing. This was a substantial improvement over the negative

GROSS DOMESTIC PRODUCT BY INDUSTRIAL ORIGIN
AT CONSTANT (1982) FACTOR COST PRICES



Central Bank of Ceylon.

growth of the previous year. Factory industry which grew by only 2 per cent in 1983 registered a sharp increase of 15 per cent in 1984, reflecting high growth in both private and public sector industry.

The growth in the services sector was largely influenced by the increased value added in wholesale and retail trade. High levels of activity in the import and export trade helped to maintain the growth momentum in services. Growth in the other services sub-sectors continued to be sluggish mainly because of the poor performance of the tourist sub-sector and the consequent decline in the demand for ancillary services. Tourism recovered partially from the setback it experienced in 1983. The relative stagnation of the construction sector was partly due to the completion of headworks of two major projects under the Accelerated Mahaweli Development Programme. The construction of the Victoria Dam and the Hydro Power Tunnel and the Minipe Right Bank Trans Basin Canal was completed during the first half of the year. Private sector construction activity also declined in 1984.

Weather conditions affected agricultural output of different sub-sectors unevenly. The poor growth in the agricultural sector was marked by the decline in output of paddy and coconut which was primarily related to adverse weather conditions, the former being affected by flood damage and the latter by the lagged effect of the drought of 1983. The most outstanding development of the agricultural sector was the recovery in the tea industry. The unusually heavy rains in the first half of the year which severely damaged food crop cultivation in the Maha season also helped tea production to recover. Tea production which had continuously declined in the past two years rose by 16 per cent over that of 1983 and approximated the level of production reached in 1981. The increased tea production combined with booming export prices brought much needed relief to producers in both the public and private sectors whose margins had been unfavourable for several years. The better performance of the tea industry was also reflected in the improved performance of the government budget and the balance of payments.

The buoyancy displayed by the tea sub sector was not shared by other sub-sectors in agriculture. Although rubber production rose in 1984, it was a marginal improvement of 1.4 per cent compared with 12 per cent recorded in the previous year. This improvement came entirely from public sector plantations. In contrast to the previous year's favourable record of growth, output of private sector rubber growers declined by 3 per cent. As already noted the lagged effect of the drought during most of 1983 depressed growth in the coconut sub-sector. Coconut production declined by 14 per cent with production declining to the lowest level recorded in the recent past. Because of the high weight of coconut in value added in the agricultural sector this adversely affected the overall performance of agriculture.

In the food crop sector, paddy as well as other minor food crops experienced a setback in 1984. However, this came about due to inclement weather and did not reflect a decline in the growth potential of this sub-sector. Paddy output in Maha 1983-1984 declined substantially by 24 per cent. However, the remarkable increase of 52 per cent in the output in the Yala season mitigated the Maha shortfall.

The performance in Yala, which depends heavily on irrigation clearly indicated the paddy sub-sector is now on a sustainable growth path. Production of other minor food crops also declined due to adverse weather in Maha but partially recovered towards the end of the year.

Sugar production registered a 15 per cent drop in 1984 thus continuing its declining trend. Poor water management has been a major reason for lower production of sugar-cane. In the case of the fisheries sub-sector, production declined substantially by 23 per cent, compared with the previous year. This was the result of the poor performance in coastal fishing. Milk production is estimated to have increased by 3 per cent, while egg production declined marginally.

A major contribution to economic growth in 1984, came from the manufacturing sector. Output in factory industry recorded a substantial increase of 15 per cent, which was the combined outcome of the improved performance of both private sector (26 per cent) and public sector industry (7 per cent). The resilience shown by the private factory industry was a noteworthy achievement in view of the disturbances experienced in 1983. The increase of output in private sector industry was also reflected in the substantial increase in exports of textile and garments and other industrial goods. The continued better performance of private factory industry is a clear indication of its favourable response to the attractive package of incentives provided by the government. Nevertheless, there is much scope for the private sector to strengthen its performance and become more competitive through improvements in productivity and management.

Output in public sector industry recorded a growth of 7 per cent. However, the overall performance of the public sector was largely influenced by the output of petroleum products which has a weight of 55 per cent in this sector. Thus operations of the petroleum refinery continued to strongly influence the performance of public sector industries. If the output of the refinery is excluded, public sector industrial output showed a decline. Most of the public sector industrial ventures are confronted with managerial, marketing and liquidity problems. When viewed in terms of production and returns to capital, public sector industrial enterprises in general have still to make optimum use of funds invested in them.

The uneven performance of agricultural production had its impact on domestic prices in 1984. A sharp increase in food prices was recorded in the first half of 1984 due to the poor supply position and revisions in administered prices. High export prices also exerted an upward pressure on domestic prices. However, an encouraging turnaround was observed towards the second half of the year, when there was an appreciable deceleration in the rate of inflation. The year on year (point to point) increase registered in the Colombo Consumers' Price Index (CCPI) at end December, 1984 was only 9 per cent compared with 21 per cent in 1983. Similarly, the Wholesale Price Index (WPI) registered a year on year (point to point) increase of 5 per cent at the end of 1984. Despite the sharp decline in prices in the second half of the year, high prices in the first half resulted in annual average prices for the year being above the corresponding average for 1983. The CCPI increased by 17 per cent on an annual average basis compared to 14 per cent in 1983 and the WPI increased by 26 per cent on the same basis as against 25 per cent in the previous year. It should be noted however, that prices continued their declining trend right upto the end of the year.

The marked deceleration in prices which helped to achieve single digit price increases (on a point to point basis) as reflected in the CCPI and the WPI by the end of the year was due to several factors; the most important factors being the improved supply situation, particularly in regard to food, the deflationary impact of the government budget, the effectiveness of restrictive monetary policy measures and an increase in savings. A decline in the rate of imported inflation combined with continued stability in the prices of some imported commodities and relatively stable exchange rates also contributed to the deceleration in prices. A noteworthy factor shown in the analysis of causes for the price decline was the contribution made by the government budget in bringing down the rate of inflation. Financing a part of the capital budget through savings generated in the current account was a significant breakthrough in budgetary discipline in ameliorating the adverse effects of large cumulative budget deficits in the past. The sharp and impressive reductions in the budget deficit complemented the monetary policy measures pursued during the year. These achievements however, do not leave room for complacency. Budgetary deficits however, are still high and will have to be pruned down to assist the private sector's ability to use more resources for expansion of production and supplies. Demand management policies therefore require sharp reductions in excess liquidity build-up through strict budgetary discipline supplemented by resolute monetary policy measures. The rate of inflation which has been brought down has to be kept down by creating necessary conditions for the maintenance of continued price stability.

Deceleration of prices towards the end of the year had a beneficial impact on real wages. The main improvement recorded in real wages was with regard to workers in Wages Boards trades. The real wages of workers in this category increased by 1.5 per cent due mainly to the real wage increase of 7.6 per cent of workers in agriculture whose money wages increased by 25.9 per cent in 1984. The moderate wage increases, received by industry, commerce and service workers governed by Wages Boards were not translated into an increase in their real wages. The money wage increase of certain categories of workers in the government sector was also moderate. The main income benefit to workers in the government sector came through two revisions made in the cost of living compensation in 1984. This kind of wage indexation may have adverse effects on demand management policies and will have to be reviewed in the light of need for pursuing a national wages policy to provide the necessary incentives to expand labour productivity consistent with growth in incomes and real wages.

The absence of firm data places limitations on reviewing developments in employment. Nevertheless, based on the sectoral growth in the economy it is reasonable to assume that there has been an increase in employment opportunities in the country. Sectoral growth in the economy indicates that direct employment opportunities in industrial ventures with or without foreign collaboration

TABLE 1.3

Investment—Savings 1980-1984

Category	1980 Rs. Mn.	1980 %	1981 Rs. Mn.	1981 %	1982 Rs. Mn.	1982 %	1983 Rs. Mn.	1983 %	1984 (a) Rs. Mn.	1984 (a) %
1. **Investment-Savings(local &foreign)**	**22,465**	**100.0**	**23,610**	**100.0**	**30,276**	**100.0**	**36,063**	**100.0**	**39,850**	**100.0**
Less : Goods and Non-Factor Services (Net)	-15,021	- 66.9	-13,666	- 57.9	-18,758	- 62.0	-18,365	- 50.9	- 8,374	- 21.0
2. **Gross Domestic Savings** ..	**7,444**	**33.1**	**9,944**	**42.1**	**11,518**	**38.0**	**17,698**	**49.1**	**31,476**	**79.0**
Add : Factor Services (Net) ..	- 432	- 1.9	- 1,868	- 7.9	- 1,959	- 6.4	- 3,214	- 8.9	- 3,356	- 8.4
Private Transfers (Net) ..	2,260	10.1	3,918	16.6	5,494	18.1	6,441	17.8	7,039	17.6
3. **Gross National Savings** ..	**9,272**	**41.3**	**11,994**	**50.8**	**15,053**	**49.7**	**20,925**	**58.0**	**35,159**	**88.2**
4. Foreign Savings (1—3) ..	**13,193**	**58.7**	**11,616**	**49.2**	**15,223**	**50.3**	**15,138**	**42.0**	**4,691**	**11.8**
Official Transfers (Net) ..	2,281	10.1	3,118	13.2	3,379	11.2	4,016	11.1	3,902	9.8
Concessionary Loans (Net)(*b*) ..	2,712	12.1	3,279	13.9	4,292	14.2	5,796	16.1	6,945	17.4
Commercial Borrowings (Net) ..	3,163	14.1	3,465	14.7	5,339	17.6	3,933	10.9	704	1.8
Direct Investment ..	710	3.2	947	4.0	1,323	4.4	887	2.5	911	2.3
Use of Net External Assets (*c*) ..	2,967	13.2	406	1.7	1,009	3.3	- 342	- 0.9	- 7,062	- 17.7
Other (Net) (*d*) ..	1,360	6.0	401	1.7	- 119	- 0.4	848	2.3	- 709	- 1.8
5. **As a percentage of GDP at Market Prices**										
(i) Investments ..	33.8		27.8		30.3		29.6		26.3	
(ii) Gross Domestic Savings ..	11.2		11.7		11.5		14.5		20.8	
(iii) Gross National Savings ..	13.9		14.1		15.1		17.2		23.2	
(iv) Foreign Savings ..	19.8		13.7		15.2		12.4		3.1	

Source : Central Bank of Ceylon.

(*a*) Provisional.
(*b*) Net foreign loan receipts of the Government excluding commercial borrowings.
(*c*) Minus (-) sign denotes overall surplus in the Balance of Payments.
(*d*) Comprises of SDR Allocations, Valuation Adjustments and Errors & Omissions in the Balance of Payments.

had increased. Expansion of rural development activities would have reduced unemployment and underemployment in the rural sector. A marginal increase was seen in employment in the government sector. However, new employment opportunities in the government sector were reduced due to restraints in government capital expenditure and efforts made to increase productivity. Measures introduced to restructure and increase efficiency in semi-government institutions also had the effect of reducing new employment opportunities in them.

The financing of investment in the face of sluggish growth in domestic savings in the past had resulted in a large imbalance between investment expenditure and available domestic resources. In the face of an unfavourable international environment and deteriorating terms of trade the need to increase the savings effort in order to maintain a high level of public and private investment has been recognised. In the last few years, the investment/savings gap has been bridged mainly by recourse to foreign savings in the form of outright grants and concessional loans. It is noteworthy that recourse to commercial borrowing was on a limited scale and did not continue beyond 1983 because of the substantial gains made in foreign exchange reserves consequent on a favourable balance of payments position. This also reduced the extent of foreign savings in total investment financing significantly. Thus, the use of foreign savings dropped from 42 per cent of gross investment in 1983 to 12 per cent in 1984. Domestic savings amounted to 20.8 per cent of GDP in 1984, compared with 14.5 per cent in the previous year, while national savings augmented largely by worker remittances, increased to 23.2 per cent of GDP. Actual inflows of foreign savings exceeded the shortfall between the gross national savings and the gross domestic investment. The result was the reduced use of foreign savings which at 3 per cent of GDP was the lowest recorded during the last six years. The excess foreign savings was reflected in the overall surplus of the balance of payments.

Growth of Gross Domestic Capital Formation (GDCF) slowed down further in 1984, when it increased by only 9 per cent compared with 21 per cent in 1983. Completion of a major part of the construction work under the Mahaweli Development Programme and the cut back in new capital expenditure by the government were mainly responsible for slower growth in GDCF. However, it is a matter for concern that despite the generous incentives available, private sector investment in a number of key areas had lagged behind. These factors have brought down GDCF to 26 per cent of GDP from the high average ratio of 30 per cent during the last four years. A salutary feature, however, has been the decline in the share of consumption in total expenditure thus indicating a shift of resources to investment. Consumption expenditure increased only by 15 per cent as against 18 per cent growth in 1983. The outcome of this development was the remarkable increase in domestic savings referred to earlier. There is a strong need to maintain this high level of domestic savings by a further strengthening of fiscal management combined with restrictive monetary policies and increased domestic production. In view of the expected levelling off in foreign aid flows and possible growth in debt service burden no slippage should be allowed in the policy efforts to contain consumption, enhance domestic savings and increase foreign earnings.

The developments in the monetary sector during 1984 were characterised by a deceleration in the rate of money and credit growth, enhancement of liquidity in the financial system and downward movement in interest rates, particularly on deposits. These developments were further augmented by a considerable deceleration in the rate of inflation. The narrow money supply (M_1) increased by 14 per cent when compared with 25 per cent in 1983, while broad money (M_2) rose by 17 per cent as against 22 per cent in the previous year.

TABLE 1.4

Monetary Magnitudes 1980 - 1984

Rs. Million

Item	1980	1981	1982	1983	1984
Change in Domestic Credit	**10,832**	**8,163**	**8,431**	**6,895**	**633**
Increase in Net Credit to Government	6,052	3,817	4,361	383	-2,979
Increase in Credit to Government Corporations	776	365	190	- 292	- 237
Increase in Credit to Co-operatives	- 540	- 74	- 106	635	- 255
Increase in Credit to Other Private Sector	4,544	4,055	3,986	6,170	4,104
Change in Net External Banking Assets	**-3,117**	**- 690**	**- 568**	**815**	**6,777**
Change in Total Assets Liabilities	**7,655**	**7,473**	**7,863**	**7,710**	**7,410**
Increase in Broad Money Supply (M_2)	4,803	4,587	6,063	6,747	6,170
Increase in Other Liabilities (Net)	2,852	2,886	1,800	963	1,240
Percentage Increases in Monetary Magnitudes					
Percentage increase in Total Domestic Credit	72·4	31·6	24·8	16·3	1·3
Percentage increase in Total Assets and Liabilities	35·2	25·4	21·3	17·2	14·1
Government as percentage of Total Domestic Credit Increase	55·9	46·8	51·7	5·6	-470·4
Non-Government as percentage of Total Domestic Credit Increase	44·1	53·2	48·3	94·4	570·4
Percentage increase in—					
Broad Money Supply (M_2)	31·9	23·1	24·8	22·1	16·6
Narrow Money Supply (M_1)	22·9	6·3	17·3	25·4	14·1

Source: Central Bank of Ceylon.

There was a marked decline in the rate of domestic credit expansion in 1984. Domestic credit rose only by one per cent compared with 16 per cent in the previous year. This substantial drop in domestic credit growth was largely due to the reduced demand for credit both by the Government and the private sector.

The Government reduced its reliance on the banking system, as increased revenue from duties and taxes substantially enhanced the resources available to the Government. The flow of foreign aid and increased subscriptions to Treasury bills and Government securities by non-bank sources further enhanced government resources. Consequently government utilized its improved cash balances to reduce its outstanding commitments to the banking system. Central Bank profits amounting to Rs. 1,650 million transferred to the Treasury were also utilized to liquidate some of the outstanding government liabilities to the Central Bank. The end result of all these developments was a 17 per cent decline in net credit to government.

Credit to the private sector, including government corporations and co-operatives rose by 11 per cent when compared with 26 per cent in 1983. The deceleration in credit to the private sector largely reflected the improved financial position of certain government corporations, particularly the two plantation corporations, and the reduction in demand for non-priority credit consequent on the credit restrictions imposed by the Central Bank during the first half of the year. Moreover, credit to co-operative institutions also declined due to the limits placed on the marketing refinance available to the Paddy Marketing Board (PMB) through the People's Bank.

The commendable achievement of the Government in becoming a net contributor of deposit resources to the banking system reversed the crowding out impact of government financial operations on the private sector (excluding government corporations and co-operatives). Within the limits placed on credit expansion the private sector had full recourse to commercial bank credit. Freeing of bank resources by the Government is consistent with its desired objective of encouraging increased private sector participation in economic development.

Monetary and credit policy measures effected during the year represented a conscious attempt towards achieving monetary stability as well as development objectives against the background of an increased liquidity situation in the economy. Several measures were introduced with a view to reducing the expansion in bank credit through Central Bank refinance schemes. These included placing of limits on marketing refinance facilities granted to the PMB and reductions in the general accommodation made available to commercial banks. Meanwhile, with a view to promoting the supply side, the pre-shipment export credit refinance facility was continued. Refinance schemes of the Central Bank came under review. The open ended refinance schemes to support non-traditional exports continued with further reductions in the interest rates. However, there was a reduction in the amount of refinance provided to non-traditional exports though provisions were made to enlarge the scheme in case the necessity arose. But the reductions in commercial bank interest rates coupled with better liquidity position due to satisfactory export performance resulted in a reduction in the use of refinance by the private sector.

Selective credit control measures were used to restrict credit expansion for non-essential imports, in particular, consumer items. Moreover, with a view to supplementing the credit restrictions imposed on commercial banks and safeguarding the interest of depositors, the liquidity ratio applicable to finance companies was raised from 5 to 10 per cent of total deposits.

In order to contain the growth of domestic liquidity, the Central Bank resorted to two specific methods. Effective June, 1984 the Central Bank issued its own securities, through which an amount of Rs. 557 million was absorbed from bank and non-bank sources. This measure was further supplemented by the introduction of marginal reserve requirements on a graduated scale thereby restricting the credit creating capacity of commercial banks.

The considerable achievements in the monetary sector were further complemented by the reduction in the velocity of money. The fiscal support extended by the Government in implementing the monetary policy measures in particular, through the reduction of government borrowings from the banking sector played a major role in reducing the rate of inflation.

The interest rate structure underwent several changes during the year due to revisions effected in the interest rate policy of the Central Bank, non intervention by authorities in the interest rate policy of the National Savings Bank (NSB) and the excess liquidity position experienced by commercial banks. The NSB reduced its one year fixed deposit rate by two percentage points in July, 1984. Commercial banks too reduced deposit rates in varying degrees and at different times. In general, the lending rates remained unchanged, except for marginal adjustments effected by certain banks in isolated cases. Interest rate structure has to remain flexible in the wake of improvements to the positive real rate of return to depositors as a result of reductions in the inflation rate and inflationary pressures.

Past Annual Reports voiced the concern of the Central Bank on the inadequacy of credit channelled to the rural sector. Using percentage terms have always camouflaged the actual coverage under the rural credit programmes. Loans given for paddy and other food crop cultivation under the Comprehensive Rural Credit Scheme amounted to Rs. 217 million in 1984, showing an increase of Rs. 36 million or 20 per cent over 1983. This increase viewed against the total credit expansion to the private sector is small. With this level of operations the banking system will hardly make a dent in the total credit requirements of the rural agricultural sector. It should also be mentioned that efforts in promoting rural credit in the country have by and large concentrated for too long on cultivation loans. There is a vast field of non-cultivation activities requiring bank finance for development.

Despite the prevalence of excess liquidity in the money market, transactions in the capital market were not impressive. This highlighted the limited availability of instruments and the lack of an institutional framework for transferring resources from the money market to the capital market.

The considerable improvement achieved in government fiscal operations in 1983 was further strengthened in 1984. The sharp increase in revenue collection and the slower growth in public expenditure reduced the budget deficit substantially. The budget deficit in relation to GDP declined from 18 per cent in 1983 to 11 per cent in 1984. An appreciable level of budgetary savings boosted domestic savings. In fact, the increase in budgetary savings was in the region of 4 per cent of GDP and accounted for nearly half the increase in domestic savings.

Total government revenue increased by 50 per cent in 1984 and the revenue as a percentage of GDP rose from 21 to 25 per cent. During the year revenue mobilization efforts were strengthened. Revenue from non-tax sources was enhanced. On the expenditure side, initiatives were taken to contain its growth by expenditure cuts and improvement in the operation of public sector corporations. However, the pressures from supplementary commitments nullified the gains realised from the expenditure cuts. Total expenditure increased by 14 per cent in 1984 compared with 24 pet cent in 1983.

TABLE 1.5

Fiscal Magnitudes 1980 - 1984

Rs. Million

Item	1980	1981	1982	1983(*a*)	1984(*a*)
Revenue ..	14,068	16,228	17,809	25,210	37,731
Expenditure ..	30,343	31,094	37,900	46,816	53,593
Recurrent Expenditure including Advance Accounts ..	16,489	17,721	19,231	25,083	31,843
Current Account Deficit (-)/ Surplus (+) ..	- 2,421	- 1,493	- 1,422	+ 127	+ 5,888
Capital Expenditure ..	13,854	13,373	18,669	21,733	21,750
Overall Budget Deficit ..	16,275	14,866	20,091	21,606	15,862
Financing—					
Foreign ..	6,735	8,208	8,794	10,950	11,226
Domestic Non-Bank ..	2,484	2,779	7,607	10,147	6,601
Domestic Bank ..	7,126	3,917	4,006	1,203	- 2,644
Use of Cash Balances ..	- 72	- 38	- 315	- 694	679

As a Percentage of G D P

Item	1980	1981	1982	1983(*a*)	1984(*a*)
Revenue ..	21.1	19.1	17.9	20.7	24.9
Expenditure ..	45.6	36.6	38.0	38.5	35.4
Recurrent Expenditure including Advance Accounts ..	24.8	20.8	19.3	20.6	21.0
Current Account Deficit (-)/ Surplus(+) ..	- 3.6	- 1.8	- 1.4	+ 0.1	+ 3.9
Capital Expenditure ..	20.8	15.7	18.7	17.9	14.4
Overall Budget Deficit ..	24.5	17.5	20.1	17.8	10.5
Financing—					
Foreign ..	10.1	9.7	8.8	9.0	7.4
Domestic Non-Bank ..	3.7	3.3	7.6	8.3	4.4
Domestic Bank ..	10.7	4.6	4.0	1.0	- 1.7
Use of Cash Balances ..	- 0.1	...	- 0.3	- 0.6	0.4

(*a*) Provisional

Sources: General Treasury, Central Bank of Ceylon.

In financing the budget deficit the Government utilized a substantial magnitude of foreign resources. Total foreign financing of the deficit increased from 51 per cent in 1983 to 71 per cent in 1984. However, in relation to GDP, resources from foreign sources declined from 9 per cent to 7 per cent. The Government also had recourse to domestic non-bank sources at a reduced level. These financing efforts mobilised resources far in excess of the resource gap for the first time since 1977. The surplus was utilised to repay a part of the debt to the banking system.

The improved international economic environment in 1984 was beneficial to many non-oil developing countries. The strong economic recovery in the United States of America gave a boost to production worldwide. But the global recovery remained uneven. Among the advanced industrial countries other than the United States only Japan and Canada registered moderately high rates of growth. Most European economies were saddled with restrictive fiscal policies and restive labour markets. The monetary policies in these countries were under severe pressure from the capital outflows to the United States. A slight downward movement in US interest rates was observed towards the third quarter of the year. Although crude oil prices firmed in the middle of the year, they faced further downward pressure. Non-oil commodity prices, in US dollar terms, after peaking at the beginning of the year, slipped somewhat towards the third quarter of the year. Inflation declined in most of the industrialised countries and averaged about 5 per cent. However, low inflation was achieved at the cost of high unemployment. Increasing unemployment in industrialised countries strengthened protectionism hindering greater expansion in world trade. Nevertheless, the strong recovery of world trade in 1984 enabled most of the developing countries to improve their overall balance of payments position.

Sri Lanka too benefited from this increased world trade. Helped by strong commodity prices and a substantial drop in prices of several major import items, Sri Lanka's terms of trade improved by 14 per cent following the increase of 16 per cent a year earlier. The result was a further increase of 7.6 per cent in real National Income (real GNP adjusted for changes in the terms of trade).

Sri Lanka's balance of payments performance in 1984 was very favourable. This reflected mainly the improved merchandise trade performance. The major impact on balance of payments came from tea exports, which increased by 83 per cent, in SDR terms, and accounted for 42 per cent of the total value of exports. Combined earnings from exports of tea, rubber and coconut increased by SDR 291 million. However, the underlying weaknesses in the balance of payments persisted. In the case of rubber and coconut, Sri Lanka was not able to reap the full benefits of high prices due to set backs in production—rubber exports increased by only 0.8 per cent, while the nut equivalent of coconut exports declined by 44 per cent. A further disconcerting feature was the continued decline in exports of minor agricultural crops. Effective measures are needed to revitalise this sub-sector. The same could be said of export of gems, which has shown a persistent decline in the last few years. A more encouraging feature of the trade performance was the large increase in exports of textile and garments and other industrial goods.

Total expenditure on imports, which declined by one per cent, in SDR terms, in 1983 recorded an increase of 1.7 per cent in 1984. Thus in the last two years import growth has been very small. Lower oil and sugar prices and near self sufficiency in rice were mainly responsible for the slower growth of import outlays. The share of aid related imports which amounted to 21 per cent in 1983, increased to 22 per cent in 1984. With the possible slowing down of international aid Sri Lanka may not be able to maintain aid related imports at these levels. It is important therefore, that measures to increase export earnings and efficient import substitution receive the highest priority.

TABLE 1.6

Summary of Balance of Payments 1982 - 1984

Rs. Million (SDR Million in brackets)

Item	1982(*a*)	1983(*a*)	1984(*b*)
Merchandise Exports ..	21,098 (918)	25,038 (993)	37,453 (1,439)
Merchandise Imports ..	41,501 (1,808)	45,206 (1,794)	47,626 (1,825)
Non-Factor Services (Net) ..	1,645 (72)	1,803 (73)	1,798 (68)
Factor Services (Net) ..	- 1,959 (- 85)	- 3,214 (- 129)	- 3,356 (- 128)
Private Transfers (Net) ..	5,494 (240)	6,441 (256)	7,039 (270)
Official Transfers (Net) ..	3,379 (147)	4,016 (160)	3,903 (150)
Current Account Balance ..	- 11,844 (- 516)	- 11,122 (- 441)	- 789 (- 26)
Overall Balance ..	- 1,009 (- 18)	+ 342 (+0·6)	+ 7,062 (+297)
Some Key Indicators			
Terms of Trade (1978=100) ..	38	44	50
Net Petroleum Imports ..	8,994 (391)	8,342 (332)	7,393 (284)
Current Account Deficit as a percentage of GDP ..	11·8	9·1	0·5
Gross International Reserves ..	11,234 (478)	13,026 (499)	18,942 (735)
Import capacity of Gross International Reserves (in months of Imports) (*c*) ..	3·2	3·2	4·5

Source : Central Bank of Ceylon.

(*a*) Revised
(*b*) Provisional
(*c*) Projected for the following year's imports in SDR terms.

The deficit in the merchandise account of the balance of payments dropped dramatically to Rs. 10,173 million (SDR 386 million) from Rs. 20,168 million (SDR 801 million) in the previous year which is a substantial decline of over 50 per cent. The deficit in the services account showed a smaller deterioration than in 1983. The deficit was mainly due to increased interest payments on foreign loans as well as the marginal decline (in SDR terms) in receipts from tourism. However, because of the gradual build up of external assets in 1984, the negative effect of these factors was largely offset by higher interest receipts.

The current account deficit in 1984, showed a marked decline. Receipts of grants-in-aid and foreign remittances from Sri Lankans working abroad were nearly sufficient to wipe out the deficit on goods and services, resulting in a current account deficit of only SDR 26 million. While official transfers were slightly lower than in the previous year, private transfers (mainly worker remittances) increased by 5 per cent. With lower oil prices and the consequent cut back in expenditure in the Middle East, prospects of maintaining the growth of worker remittances appear to be poor. Thus, medium-term improvements in the balance of payments will have to come from a more favourable balance in the merchandise trade account.

The current account deficit declined from 9.1 per cent of GDP in 1983 to 0.5 per cent in 1984. When official transfers amounting to Rs. 3,903 million (SDR 150 million) are excluded this ratio is 3.1 per cent compared with 12.4 per cent last year. Efforts will have to be made to maintain this balance of payments position, particularly because, with the phasing out of Mahaweli related aid, foreign aid flows are expected to level off while at the same time foreign debt service payments will increase.

Nearly 95 per cent of the deficit on goods and services was covered by net inflow of foreign exchange on account of both private and official transfers. This left a very small current account deficit to be financed by inflows of non-monetary capital. However, the actual inflows of non-monetary capital far exceeded the current account deficit. The result was a higher overall surplus. In 1984, the overall surplus amounted to SDR 297 million, compared with SDR 0.6 million in 1983. The level of gross external assets improved by 47 per cent and reached Rs. 18,942 million (SDR 735 million) at the end of the year. This was sufficient to finance four and half months imports projected for 1985.

The trend in the growth of external debt in recent years has been the subject of much concern, because of its implications for the management of balance of payments. Debt management must be seen in the context of the underlying trends in the balance of payments and long term prospects for economic growth. Therefore, the present policy initiatives, of discouraging commercial borrowing and emphasising export promotion and efficient import substitution are timely.

A significant change in the debt profile in 1984 was the large decline in short term loans, which resulted from the Central Bank's borrowing abroad declining from SDR 72 million in 1983 to SDR 0.5 million in 1984. A further factor which improved the debt profile was the decline in high cost commercial credit. The change in the debt profile and the improved export performance resulted in a reduction in the ratio of debt service payments to exports from 22 per cent in 1983 to 17 per cent in 1984.

There was an appreciable improvement in the energy sector in 1984. The main factors that influenced this improvement were the decline in the world oil prices, the sharp increase in the installed capacity of electricity and favourable weather conditions for hydro power generation. The use of petroleum in electricity generation dropped substantially due to improved hydro power supply during the year. This resulted in a significant decline in net petroleum imports which had a salutary impact on the balance of payments. Nevertheless, these favourable developments should not weaken policy efforts aimed at appropriate demand management and improving efficiency in energy distribution.

In sum, the economic performance in 1984 was encouraging. Achievements in several areas outstripped expectations. However, developments during the year again revealed the underlying weaknesses in the economy. Higher economic growth reflected the recovery from the prolonged drought and the setbacks of 1983 and the income effect of the improved terms of trade. A single sub-sector (tea) in the agricultural sector was largely responsible for the upturn of the economy. The current account deficit of the balance of payments, though substantially lower than in 1983, is still heavily influenced by the high level of deficit on merchandise account. Because of the underlying weaknesses, the strong and improved balance of payments position observed in 1984 may not continue.

Recent developments in the international economic environment seem to indicate that the momentum in world trade may not be sustained. Commodity price projections suggest that the terms of trade of non-oil commodity exporting countries are likely to deteriorate in the coming years. Mounting pressure for protectionism in industrialised countries is evident and could create further marketing problems for manufactured goods of less developed countries. In the wake of the international debt crisis availability of foreign aid and loans are likely to be lower than in the past. In this context Sri Lanka faces an uphill task in sustaining the recent economic achievements and in achieving higher growth rates than at present. Therefore, concerted efforts at export promotion, and efficient import substitution need to be continued. Structural changes in the key sectors of agriculture and industry are fundamental to the desired growth objectives in the medium-term. The need for a complementary monetary/fiscal policy mix involving both budgetary reform and demand management cannot be overstressed.

In the agricultural sector there is considerable potential for growth and diversification. With correct formulation and effective implementation of policies this potential could be effectively exploited. The Government's intention of revitalising the tree crop sector is reflected in its commitment to execute the Medium Term Investment Programme prepared for the State-owned plantations. Government's proposal to estabilish Stabilization Funds for the three major tree crops is a step in the right direction.

Gaps between potential yield and actual achievements in the tree crop sub-sector continue to be substantial and deserve urgent attention. It is necessary to narrow these yield differentials to ensure the long-term viability of the tree crop sub-sector. The viability of the present economic system depends largely on the performance of these highly export oriented sub-sectors and, thus, calls for productivity improvement in both State-owned and private plantations. Rehabilitation and management improvements in tea plantations are vital for enhancing export competitiveness. Sri Lanka is still a major producer of orthodox tea. Other tea exporting countries have benefited from a production mix of both CTC (cut, torn and curled) and orthodox tea. Shifting tea production in certain areas, particularly in mid grown teas, to CTC tea may be worthwhile. It will improve the competitiveness of Sri Lanka in the world tea market. Converting highly market vulnerable tea in mid-grown areas into CTC tea would increase the viability of plantations in those areas. The change in the product mix may provide some defence against price declines in the future.

The coconut sub-sector deserves closer attention in view of its high weight in value added in GDP. Producer margins continue to be non-remunerative. The market is beset with imperfections largely due to intervention by the authorities who should rather concentrate on the development of the industry.

The breakthrough achieved in paddy production has brought the country to the verge of self sufficiency in rice at current levels of consumption and relative prices. However, it is relevant to note that the import substitution potential of paddy still exists in the context of substituting rice for imported wheat. The full benefit of local paddy production should be harnessed by framing correct pricing policies and encouraging investment in processing to induce substitution of rice for wheat flour consumption. With the present increasing trend in paddy production the national buffer stock needs should be met from domestic sources rather than imports.

Several Annual Reports in the past have highlighted the need for marketing cordination between the Paddy Marketing Board (PMB) and the Food Commissioner's Department. Administrative considerations alone should not mask the realities of rationalising paddy/rice marketing in the country. Reducing the dependence on refinance facilities and shifting to commercial credit for paddy marketing activities is an area requiring early attention. At the present production level and the effective open market for rice the PMB should be permitted freedom in its market decisions.

Another issue that is surfacing with increased paddy production is the continuation of paddy farming on marginal land in the Wet Zone and on rainfed and minor irrigated land in the Dry Zone. Such land could be diverted to more economic crops after careful study of soils and cropping patterns which would involve a new approach to land utilization in certain areas. This issue should receive the attention of the proposed Land Commission. With the completion of the major headworks under the Accelerated Mahaweli Development Programme, rapid down stream development should continue to receive priority attention if the economic benefits of the programme are to be realised within a reasonable time. This calls for concerted efforts to develop infrastructure, housing and service facilities in the Mahaweli down stream irrigation systems.

The country has still not made much gains in the minor food crops sub-sector. As emphasised in previous Annual Reports, pricing policies and other incentives afforded to the paddy sub-sector should be extended to cover these crops. Other agricultural activities with attractive opportunities for import substitution are livestock development, sugar cane cultivation and processing, cultivation of pulses and development of fisheries. The Government is already committed to take up these areas for intensive development for meeting the local market requirements and also upgrade the nutritional standard of the population. The formulation of a National

Agriculture, Food and Nutrition Strategy further emphasises the importance placed by the Government for developing food crops, animal husbandry and fisheries sub-sectors for increasing export capacity, generating employment and improving the nutritional standard of the people. A concerted effort should be made to implement the proposed strategy.

Concentration on agriculture alone will not place the economy on a sustainable growth path for the future. Whilst appreciating the contributions made by high agricultural output in expanding income, employment, foreign reserves and expansion of base for industrial growth, steps will have to be taken to achieve a high rate of economic growth through outward looking export oriented non-traditional industries. Sri Lanka's ability to solve the underlying weaknesses in her balance of payments and to achieve rapid economic growth depends not only on using up excess capacity in agriculture through import substitution but also on a well designed industrial policy particularly directed towards exports. Performance in the industrial sector has been sluggish in the past. The incentive framework for industrial investment has tended to favour import substitution. However, the potential for import substituting industrial development is rather limited due to the smallness of the domestic market. Though private manufacturing industry has responded fairly well to the export-led growth strategy, industrial exports have not expanded on a broader front. Private investment in the past has been largely concentrated in areas with attractive incentives and high returns such as tourism, real estate development, trade and road passenger transport services.

During the year under review, some efforts were made to shift the import substitution bias in the incentive structure towards export promotion. These measures included duty free import of machinery for export oriented industries, 'half tax holidays' for certain selected non-traditional export industries and the introduction of a new tariff structure on the basis of effective protection. These reforms are expected to have far reaching effects on the domestic manufacturing sector. However, a viable and dynamic industrial policy is still lacking.

It is becoming increasingly obvious that the industrial sector has become the leading sector in view of the limits to growth in the agricultural sector. There is an inexorable need for a strong and effective industrial policy and an investment support programme outlining the strategy and targets to reflect market forces by a conscious effort to raise the effectiveness in the utilisation of human and other resources.

After initiating a dialogue among all concerned parties on the present industrial situation the Government has appointed a committee of senior officials to examine constraints and weaknesses in the industrial sector and to formulate an industrial strategy for the country. This is a welcome development. Improvement of productivity in industry through new technology, efficient management, diversification of the industrial base, provision of adequate incentives, improving the climate for expanding private sector investment and promoting private sector oriented research and development are some key areas for closer consideration in formulating an industrial policy. The strategy should be extended to cover the small industrial sub-sector as well, because there is tremendous potential for improvement through entrepreneur development and adoption of modern technology.

The development and the proper management of economic infrastructure services is also essential for sustained economic growth. In this context, transport and communications play a vital role in providing necessary ancillary services for increasing the level of efficiency in the economy. In Sri Lanka shortcomings in the transport system, particularly in passenger transport, continue to be a constraint for development. In order to provide a satisfactory transport service to the public the Government has permitted the private sector to operate omnibus services. Since allowing private operators to enter the market a sizeable investment has taken place in passenger omnibus services which have correspondingly reduced the burden on the public sector services. Though the private sector has provided an extensive commuter service its initial investment is now becoming obsolete. The problem of replacement of assets is now looming over the private operators. Provision for replacement is an urgent requirement to avoid a major breakdown in road commuter services. The authorities should give much needed guidance and advice to the private investors on this important issue while taking measures to increase the efficiency in the public sector services.

Concerted efforts in sectoral development towards the attainment of a high rate of growth need to be adequately supported by a productive macro economic strategy with built in progress reviews on the performance of the effectiveness of fiscal and monetary policy measures . In the past the burden of demand management fell more on monetary policy, while the major inflationary pressure emanated from the Government Budget. Improvements in budgetary policy have reversed this trend after 1983 and have effectively complemented the monetary policy measures in 1984. Further strengthening of efforts to reduce the fiscal imbalance needs to be stressed in order to reduce the overhang of liquidity through cumulative budget deficits and promote productive investments consistent with a high level of savings.

The major thrust for reducing the budgetary imbalance has to come through an increase in the level of buoyancy and elasticity of the revenue structure. Opportunities for cutting back recurrent expenditure without further curtailing welfare measures, thereby endangering the social gains already achieved are limited. Recurrent expenditure management should be strengthened by measures to improve productivity and accountability. Widening the revenue base and introducing effective measures for better compliance by tax payers should bring about the desired increase in government revenue. The time is ripe for a revision of investment incentives and tax holidays in the context of broader economic objectives. As stressed in past Annual Reports, commercial and manufacturing public enterprises must operate at a profit and pay dividends to the Government. The restructuring of public enterprises should be implemented with urgency. Careful thought should be given to freeing from government control some of the public commercial and industrial ventures that could be better run by the private sector. However, the policy of privatization of certain public enterprises must be implemented only after the latter have been given an opportunity to improve management and efficiency.

The attainment of a high rate of economic growth consistent with employment and income distribution objectives has to be orchestrated with balanced economic progress in all sectors harnessing the advantages offered by existing growth potentials. With heavy investments in infrastructure, particularly in irrigation, hydro power and land development the stage is now set for appropriate policy initiatives for aiming at a high level of economic growth with a viable balance of payments position. The stability and consistency of economic policies will have to be strengthened to provide the confidence for the delicate and difficult process of structural adjustments that is demanded under current world economic conditions with a sense of realism and relevance for rapid improvement of per capita incomes within the shortest possible time.