PART I

ECONOMIC PERFORMANCE, PROBLEMS AND POLICIES IN 1985

ECONOMIC PERFORMANCE — 1985

Overview

The achievement of an overall economic growth rate of 5 per cent in 1985 with price stability was remarkable in an unfavourable external economic environment and internal unrest in some parts of the country. The sources of this growth were mainly from agriculture and manufacturing.

The growth of Sri Lanka's Gross Domestic Product (GDP) by 5 per cent compares with a 5.1 per cent increase in 1984 and a 5 per cent growth in 1983. The decreased net outflow of factor income resulted in the real Gross National Product (GNP) increasing by 5.3 per cent compared to an increase of 5.1 per cent in 1984 and 4.1 per cent in 1983. The GNP at current factor cost prices was 6.7 per cent higher than in 1984. Per capita GNP increased by 3.7 per cent to reach Rs. 9,219 (US $ 339) in 1985.

The increase in the implicit GNP deflator by only 1.5 per cent is in sharp contrast to an increase of 17.4 per cent in the previous year. The increase in consumer prices as indicated in the Colombo Consumers' Price Index (CCPI) was also 1.5 per cent. This increase in the CCPI was the lowest since 1978. The improved supply of agricultural commodities, relative stability in import prices, stable domestic prices of petroleum products, the lagged effect of the non expansionary fiscal policies of 1984 and the effects of the restrictive credit policies pursued since 1984 were the factors responsible for this low rate of inflation.

The decline in commodity prices, particularly of tea and coconut, was a significant adverse economic development in 1985. The continued reduction in tourist traffic and the consequent decrease in tourist dependent service industries, the increased expenditure on defence related activities, slowing down of foreign investment and disruption of economic activities in the northern and eastern parts of the country were the other major unfavourable economic developments in 1985.

Despite these adverse factors, the economy grew at an impressive rate owing to the continued expansion in the agricultural sector which accounts for about one-fourth of the country's GDP. Paddy production, which fell in 1984 due to transitory adverse weather conditions, returned to its recent high growth path to record a 10 per cent growth in 1985. Coconut production increased sharply by 52 per cent. Tea production, which increased by 16 per cent in the previous year moved up a further 3 per cent. These developments in both domestic agriculture and plantation crops together with their consequential impact on agro-processing and trade were largely responsible for the maintenance of a 5 per cent growth rate.

Industrial production which increased in 1984 by 15 per cent continued to grow though at a slower rate of 5 per cent. The growth was once again in private sector industries, whose value of industrial output increased by 20 per cent. While private manufacturing registered this high rate of growth on top of a 26 per cent growth in 1984, public industrial sector industries, declined by 6 per cent in 1985.

Indications are that employment generation in 1985 was somewhat limited. Government sector employment is estimated to have increased by 1.5 per cent but employment in semi-government institutions declined by 2.4 per cent. The decline in employment in semi-government institutions is largely a reflection of economic rationalization in several public sector enterprises and the privatisation of a few semi-government enterprises with poor performance. Private sector employment, however, appears to have increased somewhat, both in the organised and unorganised sub-sectors, though firm data are not yet available.

The country's trade performance was unfavourable mainly due to the sharp decline in export prices. For the first time since 1972 the value of exports declined, while import outlays grew at a faster rate than in the previous two years.

The magnitude of the impact of commodity price declines can be gauged by the fact that tea prices declined by 26 per cent, rubber prices by 23 per cent and coconut prices by 49 per cent. The export of textiles and ready-made garments, which had displayed a continuous increase since 1977, declined by 1 per cent and exports of other industrial products increased by 4 per cent. Despite an increase of 11 per cent in petroleum product exports, the combined export earnings from all non-traditional exports increased by only 8 per cent.

The increased expenditure on merchandise imports was a result of higher imports of consumer and intermediate goods. Increased imports of food items—rice, sugar and wheat—were the main reasons for the higher expenditure on consumer imports. Larger fertilizer imports accounted for the increased outlay on intermediate imports.

The substantial deterioration in the balance of payments in 1985 is one of the most serious adverse developments. The deterioration in both the current account and the overall balance was mainly due to the deterioration in primary commodity prices, the poor performance of most non-traditional exports and increased import volumes.

Important steps taken in recent years to improve the energy situation showed significant results in 1985. The increased generation of hydro-electricity in 1985 was due to enhanced installed capacity and sufficient water levels in reservoirs. The increased supply of hydro-electricity not only enhanced the energy supply, but also reduced significantly oil based thermal power generation and reduced petroleum consumption. Consequently, the share of petroleum in the total supply of commercial energy declined from 60 per cent in 1984 to 54 per cent in 1985. These developments combined with low international prices for petroleum, resulted in a decrease in the value of petroleum imports by 9 per cent in SDR terms thereby reducing the pressure on the balance of payments.

There was a reversal of the trend in government fiscal operations of the previous two years. The budgetary operations in 1985 were more expansionary than in the previous year. Shortfalls in government revenue from exports, largely due to decreased export commodity prices, and continued expansion in government expenditure, mainly due to defence related activities and losses in public enterprises, increased the budget deficit. In financing the deficit, government resorted to expansionary sources of financing as available resources through foreign and non expansionary sources were lower than required.

A deceleration in monetary aggregates, a sharp increase in net credit to government, a moderate increase in credit to the private sector, a decline in net external assets of the banking system and reduced deposit rates were the main monetary and credit developments in 1985.

The continuous deceleration in monetary aggregates for the second year in succession was achieved against a background of a sharp increase in net credit to government, a moderate increase in credit to private sector and a decline in external assets (net) of the banking system. The narrow money supply (M_1), increased by 12 per cent during the year compared with an increase of 14 per cent in 1984 and broad money supply (M_2) increased by 11 per cent in 1985 compared to 17 per cent in the previous year.

Gross National Product, Income and Expenditure

In 1985, real GDP increased by 5.0 per cent compared with 5.1 per cent in 1984. The decreased net outflow of factor income resulted in real GNP increasing by 5.3 per cent, compared to an increase of 5.1 per cent in 1984.

Gross National Product at current factor cost prices is estimated at Rs. 146 billion in 1985—an increase of 6.9 per cent from that of 1984. The implicit price deflator is estimated to have increased by only 1.5 per cent, in contrast to the increase of 17.4 per cent in the previous year. This marked decline in the GNP deflator is mainly due to the decrease in export prices of major agricultural products.

Sri Lanka's mid year population in 1985, provisionally estimated at 15.8 million, registered a 1.5 per cent growth over the 1984 estimate. Therefore, per capita GNP increased by 5.3 per cent to Rs. 9,219 (US $ 339). Per capita income is estimated to have increased by 3.7 per cent in real terms.

The rate of expansion of Gross Domestic Expenditure (GDE) continued to slow down. It was 10.0 per cent in 1985 compared with growth rates of 18.6 per cent in 1983 and 16.4 per cent in 1984.

The GDE at current market prices in 1985 increased by Rs. 16.3 billion over the previous year to reach Rs. 179 billion. Private consumption expenditure increased by 10.7 per cent to reach Rs. 123.2 billion in 1985. Of this figure, the expenditure of Rs. 27 billion on foreign goods and non-factor services was an increase of 24.3

per cent over the previous year, while the expenditure of Rs. 96.2 billion on locally produced goods was an increase of 7.4 per cent over that of the previous year. Public sector consumption expenditure increased by 23.4 per cent over the previous year.

Gross Domestic Capital Formation (GDCF), which includes changes in stocks, increased by only 4.1 per cent compared with a growth of 13.0 per cent in the preceding year. Capital formation in the private sector and public corporations together decreased by 7.3 per cent, in contrast to a growth of 11.8 per cent in 1984. In the government sector, gross capital formation increased by 57.3 per cent in 1985 compared to an increase of 18.9 per cent in the previous year.

Gross Domestic Fixed Capital Formation (GDFCF) increased by 3.9 per cent compared to an increase of 11.9 per cent in the previous year. The total value of imported investment goods decreased by 17.1 per cent in 1985 as compared with an increase of 5.0 per cent in 1984 and the import content of Gross Domestic Fixed Capital Formation redueed to 23.1 per cent in 1985, compared to 28.9 per cent in 1984. The completion of headworks of the Mahaweli Scheme resulted in a large reduction in capital goods imports.

In 1985 the predominant share (73.2 per cent) of Gross Domestic Fixed Capital Formation, was within the private sector and public corporations. As in 1984, the largest share of capital formation was in building and other construction. Capital formation in land development and replanting increased by 32.1 per cent.

The total resources available to the economy in 1985 was Rs. 221.3 billion ; of which Rs. 159.8 billion came from domestic sources and Rs. 61.5 billion from imports. Domestic resources accounted for 72.2 per cent of resources in 1985 compared to 74.2 per cent in 1984. While 18.7 per cent was expended on capital formation, 62.3 per cent was spent on consumption. The comparable figures for 1984 were 19.2 per cent on capital formation and 59.5 per cent on consumption. The exports of goods and non factor services amounted to 19.0 per cent of the total resources in 1985 as against 21.4 per cent in 1984.

In contrast to the two previous years, domestic savings decreased by 28.3 per cent in the current year: from Rs. 30.6 billion in 1984 to Rs. 21.9 billion in 1985. Domestic savings were 13.7 per cent of GDP at market prices in 1985 compared to 19.9 per cent in 1984. Total national savings, which include net foreign factor income and private transfers decreased by 24.6 per cent to reach Rs. 25.8 billion in 1985. The ratio of national savings to GDP fell from 22.2 per cent in 1984 to 16.1 per cent in 1985.

Sectoral Performance

The most significant sectoral growth in 1985 was in agriculture. The most pronounced increases were in coconut and paddy production, both of which had declined in the previous year.

Tea production which increased by 16 per cent in 1984 increased by a further 3 per cent from 208 million kgs. in 1984 to 214 million kgs. in 1985. A significant development in tea production was that almost the entirety of the increased production came from low grown teas which for the first time contributed the largest proportion of total tea production. The higher increase is indicative of a positive response by small holder cultivators to remunerative tea prices in the previous year.

Rubber production which had reached a plateau in recent years, declined by 4 million kgs. to 138 million kgs. in 1985. Both the acreage under tapping and yield levels remained virtually static and excessive rain in producing areas reduced tapping. As in the previous year, the entire drop in production was on public sector estates.

Coconut production increased by as much as 52 per cent to reach a new peak of 2,958 million nuts which is the highest output since 1972. Favourable weather conditions in the preceding year and increased fertilizer application accounted for this increase.

Paddy production, which registered a decline last year due to unfavourable weather conditions recovered in Maha '84 – '85 to reach 1.75 million metric tons. This 29 per cent increase from the previous Maha was unfortunately set off to some extent by a decline of 14 per cent (150,000 metric tons) in Yala 1985 when floods affected the crop in many paddy producing areas of the country. Consequently, the net increase in 1985 was only 10 per cent. Some of the Dry Zone paddy producing areas achieved very high average yields. Foremost among them were the Udawalawe, Mahaweli "H" area and Polonnaruwa districts.

The performance of minor food crops continued to be poor in 1985. The availability of adequate water for paddy production in Maha was an important factor in reducing the area under cultivation of food crops during this season. There was increased production of minor food crops in Yala, which only partly off-set the Maha decline.

There was increased production of chillies, red onions, ground nuts and black gram. The reduced supplies of chillies and red onions from the northern and eastern provinces were a spur to its cultivation in other areas. On the other hand, rice substitutes such as maize, soya and yams appear to have decreased in production owing to the lower prices for rice and the availability of better irrigation facilities for rice growing areas.

Indirect estimates derived from export data indicate that production of most minor export crops declined. Production of pepper, cloves, nutmeg, betel leaves and essential oils appear to have declined substantially. Seasonal factors may have influenced the lower output. In contrast, the increased production of coffee, cardamom, sesame and cocoa in 1985 indicates their response both to good international prices and better facilities.

Industrial output increased by 5 per cent in 1985 compared with 15 per cent in the previous year. The slower growth in industrial output was mainly due to the decline in petroleum output of the refinery and the poor performance of some important public sector industrial corporations. The value of private sector industry increased by 20 per cent, but public sector industry declined by 6 per cent. When the petroleum industry is excluded, other public sector industries grew by 2 per cent. The disturbances in the northern and eastern provinces resulted in the poor performance of some public sector industrial corporations located in this region.

In the private sector, increases in food beverages and tobacco, textiles and wearing apparel and paper and paper products pushed up output by 20 per cent. Unfavourable external and domestic factors influenced industrial performance in 1985. Lower demand for industrial exports and non-tariff barriers had a dampening effect on the growth of exports.

The limited growth in the mining and quarrying sector was due to decreased demand for construction materials and lower exports of gems. The construction sector, which registered very high rates of growth from 1978 to 1980, has been sluggish since, due to the completion of most construction in the Mahaweli Scheme, the pent up demand for housing being somewhat satisfied, decreased construction activity in the public sector and a shift to low cost construction in public housing.

The services sector grew minimally owing to the continued depression in tourist related services. Tourist arrivals declined by 19 per cent and tourist earnings in SDR terms declined by 30 per cent. Such earnings were about Rs. 2,000 million or SDR 72 million in 1985. In relation to 1982, when tourism had reached a peak, tourist arrivals in 1985 were as much as 37 per cent less. This decline in tourism resulted in a continued underutilization of hotel capacity, retrenchment of hotel staff and stagnation in tourist related services.

Prices, Wages and Employment

The deceleration of prices was a pronounced feature of economic developments in 1985. Consumer prices as measured by the Colombo Consumers' Price Index rose by only 1.5 per cent in 1985. This was in contrast to an annual average increase of 17 per cent in 1984. On a point to point basis too, (December to December) the CCPI increased by 1.5 per cent compared to a 9.5 per cent increase between December 1983 and December 1984. This slow growth in consumer prices was the lowest since 1978 and compares very favourably with international consumer price increases.

Foremost among the reasons which contributed towards the low increases in prices was the increased production and availability of agricultural commodities and depressed international prices of tea and coconut. Consequently, food prices increased only marginally. Stable fuel prices and lower import price increases of only 3.2 per cent in 1985 compared to 10.4 per cent in 1984 were also significant factors. These developments were supported by the continuation of the restrictive monetary and credit policies introduced in 1984 and the lagged impact of non expansionary fiscal policies of 1984.

Consequent on a sharp decrease in prices of tea and coconut and a moderate decrease in rubber prices, the Wholesale Price Index declined by as much as 50 per cent in 1985. The unusually large decline in the Wholesale Price Index in 1985 must be interpreted with caution in view of the fact that it increased sharply in 1984 owing to an export price boom.

In contrast to the experience of recent years, real wage levels increased significantly in 1985 due mainly to the low rate of inflation. The minimum wage rates of workers in the government sector, excluding school teachers, increased by 15 per cent owing to the payment of an additional allowance of Rs. 100 in January 1985. Real wage rates in the public sector increased by 14 per cent. A revision of salaries of government school teachers resulted in their wage rate index increasing by 17 per cent and real wages by 15 per cent. Wage rates of Wages Boards Trades employees increased by 9 per cent. The highest increase was among workers in Industry & Commerce (14 per cent) while wage rates in the agricultural sector increased by 10 per cent.

Employment in the government sector increased by 1.5 per cent, while employment in semi-government institutions declined by 2.4 per cent. The main reasons for the decline in employment in semi-government institutions were the discontinuation from work of casual workers in state plantations consequent on a reorganisation of their work force and decreases in employment in several corporations such as Hardware, Cement, Paper Products and Steel. Employment increased in semi-government institutions connected with the production of petroleum, building materials, tyres and tubes, textiles, housing and transport.

Although there are no firm data on employment in the private sector, indications are that employment in both the organised and unorganised private sectors increased. The increase in private sector employment may have, however, been at a slower rate than in the previous year. The Survey of Planned Investments of the public and private limited liability companies indicates an expected growth in employment of nearly 11 per cent in 1985/86 compared to 8.6 per cent in 1984/85.

Trade

Sri Lanka's trade performance was unfavourable in 1985. While exports declined for the first time since 1972, imports grew at a higher rate compared to the last two years.

In SDR terms, export earnings declined by 8.8 per cent while expenditure on imports increased by 5 per cent. Consequently, the trade deficit increased sharply in contrast to 1984 when export earnings increased by 44 per cent while import expenditure increased by only 0.6 per cent.

The decline in exports was largely due to lower earnings from tea and rubber. Although there was a drastic drop in coconut prices in the international market, the exceptionally high volume of coconut exports resulted in increased export earnings from coconut products. Other exports such as minor agricultural crops and gems also declined. Textiles and garments which in the past showed rapid increases, declined in real terms.

The increase in imports was largely due to the higher outlays on consumer goods; particularly food and drink and other consumer goods. The growth in consumer imports in a context of decreased export earnings had serious implications for the balance of payments.

Provisional Customs data indicate that the expenditure on imports was Rs. 49,069 million (SDR 1,776 million) and the earnings from exports was Rs. 35,035 million (SDR 1,268 million). The resulting deficit of Rs. 14,034 million (SDR 508 million) was 34 per cent higher in SDR terms than that of the previous year when it was Rs. 9,907 million (SDR 380 million). When Customs data are adjusted for lags and other factors relating to recording, the trade deficit was Rs. 16,710 million (SDR 605 million). This was 55 per cent higher in SDR terms than the deficit of Rs. 10,194 million (SDR 391 million) in 1984.

After a considerable improvement in the terms of trade in the last two years, the unfavourable prices of both exports and imports resulted in a deterioration of Sri Lanka's terms of trade in 1985 by almost 23 per cent. As measured by the Central Bank's new trade indices, export prices decreased by 15 per cent, while import prices increased by 11 per cent. The export/import ratio widened in 1985 : exports which amounted to 79 per cent of total imports in 1984 dropped to 68 per cent in 1985. Thus, the ability to finance imports from own resources weakened and recourse to foreign financing increased. In an emerging international economic environment where aid may be more difficult to obtain this level of foreign financed imports may not be sustainable in the future.

Balance of Payments

In 1985 the balance of payments outcome deteriorated substantially both in terms of the current account and the overall balance. Deficits in the merchandise and services accounts widened, net private transfers decreased marginally and official transfers indicated a substantial drop during the year. Consequently, the current account deficit increased as a ratio of GDP, from 0.8 per cent in 1984 to 7.2 per cent in 1985.

The deficit in the merchandise account in 1985 was Rs. 19,328 million (SDR 697 million) compared with Rs. 11,850 million (SDR 453 million) in 1984. In SDR terms, exports dropped by 10.0 per cent and imports increased by 5.3 per cent.

Import outlay on consumer goods and intermediate goods increased while those on investment goods declined during the year.

The deficit in the services account nearly doubled in SDR terms during the year. Increases in the net outflows of foreign exchange on account of port, transportation and insurance; a decline in net foreign exchange earnings from tourism and the increase in net outflows on account of other miscellaneous services were the main reasons for the enlarged deficit in the services account. Interest payments continued to be the largest debit item in the services account in 1985, but the net outflow was marginally lower in 1984. Services account which eased the pressure on the balance of payments from 1977 to 1981 was not able to play the same role in the last four years. Net outflow of foreign exchange through the services account amounted to 30 per cent of the current account deficit in 1985.

Although foreign exchange inflows of private remittances increased by 5 per cent in Rupee, terms they decreased marginally in SDR terms: Rs. 8,020 million (SDR 291 million) in 1985 compared with Rs. 7,653 million (SDR 294 million) in the previous year. Net receipts of private transfers declined by 2 per cent and amounted to Rs. 7,298 million (SDR 265 million) in 1985. As in the previous year, private transfers, next to tea, constituted the largest single credit item in the current account of the balance of payments during this year. Official transfers, which include project and commodity grants decreased during the year.

The net inflows of non-monetary capital to both private and public sectors were not sufficient to finance the entire deficit in the current account. A resulting deficit in the overall balance amounting to Rs. 1,060 million (SDR 111 million) was bridged by the running-down of net external assets. This outcome contrasts with the developments in 1984 when there was a surplus of Rs. 7,062 million (SDR 297 million) in the overall balance.

In 1985 Sri Lanka's gross external assets declined by 17 per cent in SDR terms. Reflecting the sharp deterioration in the overall outturn of the balance of payments, the net external assets declined by 39 per cent during the year. The level of gross external assets at the end of 1985 was sufficient to finance 3.8 months' imports projected for 1986.

The Sri Lanka Rupee depreciated against all major currencies during 1985. The Sri Lanka Rupee depreciated by 4.1 per cent against the US Dollar. The Rupee depreciated by 25 per cent each against the Deutsche Mark and the French Franc while depreciating by 23 per cent each against the Japanese Yen and the U.K. Pound.

Sri Lanka's nominal effective exchange rate (NEER), defined as the trade weighted nominal exchange rates of the major trading partners, depreciated by 16.0 per cent in 1985. The real effective exchange rate (REER), the index adjusted for inflation differentials between Sri Lanka and these trading partners depreciated by 10.8 per cent in 1985.

Sri Lanka's total outstanding debt including short-term loans and trade credits increased by 4 per cent in SDR terms and its ratio to GDP increased from 52 per cent in 1984 to 54 per cent in 1985.

In the absence of new drawings from the IMF, Sri Lanka's debt obligations to the IMF decreased to Rs. 7,914 million (SDR 293 million) in 1985, from Rs. 8,644 million (SDR 328 million) in the previous year.

The total debt service payments to export earnings from goods and services (in SDRs) increased from 17.5 per cent in 1984 to 22.4 per cent in 1985. This sharp increase was due to the combined effect of the reduction in export earnings and increases in debt service payments. The Debt Service Ratio excluding IMF transactions increased from 14.5 per cent in 1984 to 18.5 per cent in 1985. The overall debt service payments as a ratio of the receipts from merchandise exports, services and private transfers increased from 15.0 per cent to 19.0 per cent between 1984 and 1985

Fiscal Performance

The budgetary operations in 1985 were more expansionary than in the previous year. Shortfalls in government revenue largely due to decreased export commodity prices and continued expansion in government expenditure, mainly due to defence related expenditure accounted for an increased budget deficit and consequent expansionary financing.

The deceleration in government revenue was largely the outcome of sharp decreases in major export commodity prices which resulted in a fall in export duties. Government revenue from export duties fell by 41 per cent in 1985.

Government expenditure increased from Rs. 53,592 million to Rs. 67,103 million. Despite the considerable growth in current expenditure, the government managed to generate a surplus in current account operations though the amount was considerably lower than that in the previous year. However, capital expenditure at Rs. 31,332 million was 44 per cent greater than the previous year.

As a result of lower government revenue and higher expenditure, the size of the budget deficit was nearly twice that of 1984. It increased from Rs. 15,861 million to Rs. 29,759 million. This resulted in the budget deficit increasing from 10 per cent of GDP in 1984 to 19 per cent in 1985.

In financing the deficit, government resorted to expansionary sources of financing as available resources through foreign and non expansionary sources were lower than required. Domestic financing through non-bank sources increased from Rs. 6,588 million to Rs. 10,597 million. The proportion of foreign financing of the deficit declined to 43 per cent in 1985 from 71 per cent in 1984. As a proportion of GDP foreign financing increased from 7 per cent in 1984 to 8 per cent in 1985.

Monetary and Credit Developments

The sharp growth in net credit to government (NCG) largely influenced monetary developments in 1985. The progressive growth in NCG was more evident during the second half of the year when it rose from 15 per cent at the end of June to 42 per cent at the end of 1985. This large growth in NCG in 1985 was in contrast to a decrease of 17 per cent at the end of 1984.

In contrast, gross credit to the private sector (GCPS) decelerated in 1985. GCPS which grew at 11 per cent at end 1984 declined to 9 per cent at end 1985 due largely to a decrease of 17 per cent in credit to co-operatives. This decrease in credit to co-operatives throughout 1985 was due to the limited role played by the Paddy Marketing Board in paddy procurement and the considerable decline in loans granted under the Comprehensive Rural Credit Scheme during both Maha 1984/1985 and Yala 1985. The deceleration in credit to the other private sector from 16 to 11 per cent during 1985 was largely due to the continuation of restrictive monetary and credit policy measures introduced since March, 1984, the sluggish demand for credit, particularly for tea exports, and the deceleration in the inflation rate. Meanwhile, external assets (net) of the banking system recorded a decline of 7 per cent at end 1985 compared to a growth of 213 per cent at end 1984.

The above changes resulted in the annual growth in broad money supply (M_2) declining to 11 per cent at end 1985, compared to 17 per cent at end 1984. Despite the sharp growth in NCG, the growth in M_2 was contained at this level due to a considerable increase (Rs. 3,627 million) in other items (net) of the banking system in 1985. The outstanding Central Bank securities amounting to Rs. 1,168 million at end 1985 and the revaluation of external assets of the Central Bank were mainly responsible for the increase in other items (net). Meanwhile, the annual growth in narrow money (M_1) which had reached 14 per cent at the end of 1984 decelerated in the first quarter, but rose in the next two months to reach a peak level of 20 per cent at end May, 1985. Though M_1 was erratic in the second half of the year, at the end of 1985 it declined to 12 per cent. This compares with increases of 25 and 14 per cent at the end of 1983 and 1984, respectively. Reflecting largely the deceleration in the inflation rate, income velocities of both narrow and broad money declined from 8.3 and 3.2 in 1984 to 8.0 and 3.1 respectively, in 1985.

The reduction in deposit rates by the National Savings Bank(NSB), the excess liquidity situation created by the credit ceilings and enhanced government expenditure induced commercial banks to reduce their deposit rates initially and then lending rates. State banks reduced lending rates by 1 to 3 percentage points mainly on priority lendings with effect from 1st October, 1985. Despite the decline in deposit rates of commercial banks their total time and savings deposits (quasi-money) continued to rise. This may have resulted from the positive real rate of interest on financial deposits due to the deceleration in the inflation rate. Finance companies also lowered their deposit rates.

In view of the drop in money market rates and the deceleration in the rate of inflation, interest rates on government securities were reduced from 16 to 14 per cent per annum with the maturity period remaining at 6 years with effect from 1st September 1985. Similarly, the rate on primary Treasury bills fell from 14 to 11.5 per cent per annum while buying and selling rates on secondary Treasury bills dropped from 14.2 and 14.0 per cent per annum to 11.5 and 11.3 per cent per annum, respectively.

The year ended with the Central Bank announcing a two percentage point reduction in the Bank Rate from 13 to 11 per cent per annum and a similar reduction was effected in all refinance rates except those of cultivation and marketing refinance facilities. Following these developments the Treasury bill rate fell to 11 per cent per annum.

Despite the prevalence of excess liquidity in the money market, there were only three new share issues offering Rs. 87 million worth of shares to the public during 1985. The limited transactions in the share market indicates the limited availability of instruments and the lack of an institutional framework for the transfer of resources from the money market to the capital market.

Credit ceilings imposed on private sector credit and high reserve ratios imposed on incremental deposits of commercial banks during 1984 continued to be in force during 1985. With a view to absorbing excess liquidity the Central Bank increased the statutory reserve ratios on all deposits. In response to these monetary policy measures the end year money multipliers of both narrow and broad money decreased from 1.2 and 3.1 in 1984, to 1.1 and 2.8 respectively, in 1985.

The restrictive monetary policy stance adopted in 1984 was continued together with selective policies to ensure adequate credit to priority sectors. Several measures were adopted during 1985 with a view to providing credit to priority sectors thereby promoting the supply side in the economy. The main measures initiated for this purpose were the exemption of exports and agriculture loans from the credit ceilings, reduction in refinance rates on exports and the enhancement of the liquidity base of the Development Finance Corporation of Ceylon (DFCC).

In June, 1985 commercial banks were permitted to maintain a part of their required reserves on time and savings deposit liabilities in DFCC bonds subject to the quantum of reserves so maintained by each commercial bank not exceeding one eighth of its reserves on time and savings deposit liabilities. This enhanced the DFCC's capacity to lend to the private sector. At end 1985 commercial banks' investments in DFCC bonds amounted to Rs. 333 million.