

ECONOMIC PERFORMANCE, PROBLEMS AND POLICIES 1987

Introduction

The year 1987 marked a considerable slowing down of Sri Lanka's economic performance. In real terms, the Gross Domestic Product (GDP) is estimated to have increased by 1.5 per cent—the lowest since the economic reforms of 1977. The average rate of growth of the real GDP during the 10 year period 1977–1986 was 5.5 per cent. Meanwhile, the Gross National Product (GNP) in 1987 at constant (1982) prices, which is derived by allowing for the flow of net factor income from abroad, recorded a growth rate of 1.6 per cent. This compared with a real GNP growth rate of 4.5 per cent in the previous year.

TABLE 1.1
National Income Statistics 1985-1987

Item	Amount (Rs. Million)			Growth Rate	
	1985	1986*	1987*	1986	1987
1. G.D.P. at Current Factor Cost Prices ..	148,321	163,713	177,731	10.4	8.6
2. G.D.P. at Constant (1982) Factor Cost Prices ..	109,570	114,261	115,922	4.3	1.5
3. G.N.P. at Current Factor Cost Prices ..	144,921	159,852	173,395	10.3	8.5
4. G.N.P. at Constant (1982) Factor Cost Prices ..	105,741	111,565	113,307	4.5	1.6
5. Mid Year Population ('000) ..	15,837	16,117	16,361	1.8	1.5
6. G.N.P. per Capita					
(i) At Current Prices (Rs.) ..	9,151	9,918	10,598	8.4	6.9
(ii) At Constant (1982) Prices (Rs.) ..	6,740	6,922	6,925	2.7	0.1

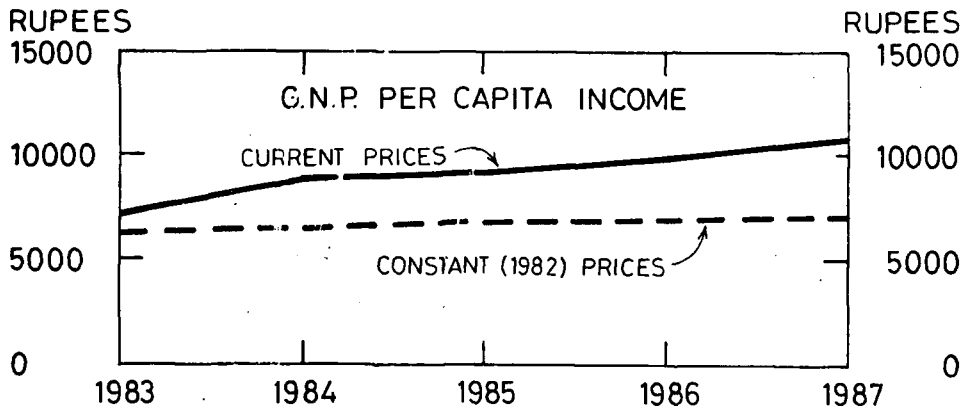
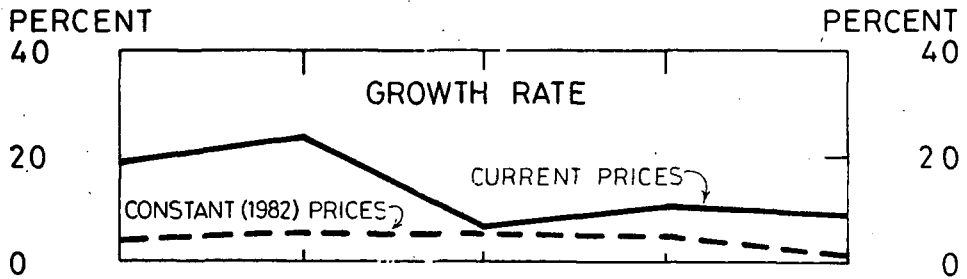
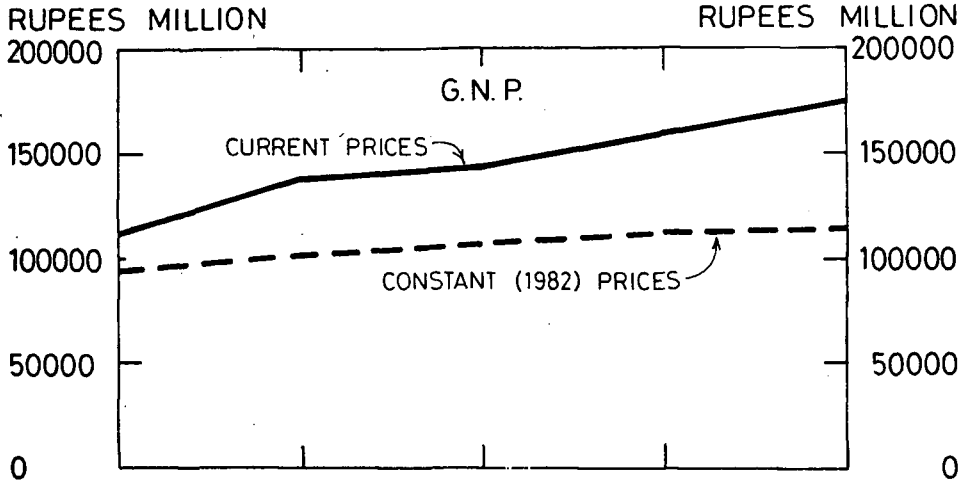
* Provisional

Source: Central Bank of Sri Lanka.

In 1987, GNP at current factor cost prices is estimated at Rs. 173.4 billion showing a growth of 8.5 per cent. During the year, the implicit GNP deflator, a measure of the overall price change in the economy, rose by 6.8 per cent, a rate slightly higher than 5.5 per cent recorded in 1986. Accordingly, the estimated GNP at constant (1982) prices in 1987 was Rs. 113.3 billion, showing a growth rate of 1.6 per cent. On account of a slight turnaround in the terms of trade, the real national income, which is derived after adjusting for the terms of trade effect, increased by a slightly higher rate of 2.1 per cent.

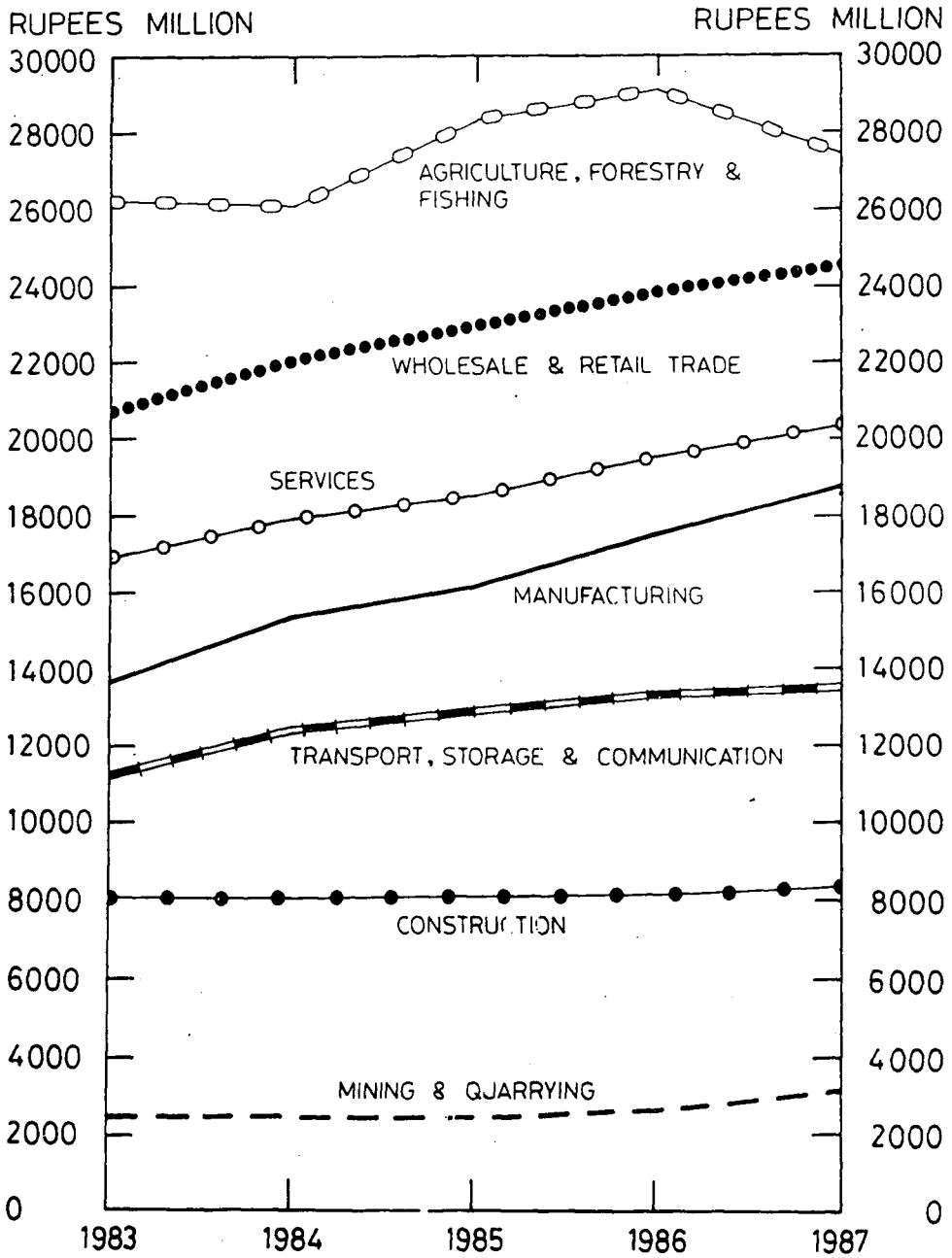
The provisional estimates of the Registrar General show that Sri Lanka's population increased by 1.5 per cent in 1987 to 16.4 million. On this basis, per capita GNP at current prices is estimated at Rs. 10,598 (US\$ 360) in 1987. In real terms, however, per capita income showed a negligible increase of only 0.1 per cent.

GROSS NATIONAL PRODUCT



GROSS DOMESTIC PRODUCT BY INDUSTRIAL ORIGIN

AT CONSTANT (1982) FACTOR COST PRICES



The modest economic performance in 1987 had been the outcome of a combination of factors. Foremost among them was a pronounced set-back to agricultural production. Under the impact of adverse weather, and continuing civil disturbances in the Northern and Eastern regions, value added in the agricultural sector as a whole declined by 8 per cent in 1987. Among the plantation crops, only tea showed some resilience, with an output growth of 1 per cent. The production of rubber declined by 11 per cent and of coconut, by 25 per cent. In the food crop sector, the output of paddy dropped by 18 per cent, and sugar, by 15 per cent. Another sector which performed below expectations was the services sector, where value added increased by only 2.7 per cent, as compared with a growth of 4.3 per cent in 1986.

Among the sectors which provided some impetus to growth in 1987 were the manufacturing sector and the mining and quarrying sector. In the manufacturing sector, the value added in private sector industries increased by 13 per cent, while that in state owned industries declined by 3 per cent. Meanwhile, export-oriented agricultural processing recorded a growth of 4 per cent, largely owing to a switching of tea production toward high value added products. The production of tea in packeted form increased by 15 per cent during the year. The overall output growth in the manufacturing sector was 7 per cent in 1987, and the overwhelmingly larger share of this occurred in factory industry, the output of which weighs heavily in the total production of this sector. According to Central Bank's Survey of Industrial Production, the industrial groups showing noteworthy increases were textile and wearing apparel, fabricated metal products, chemicals and non-metallic mineral products. Largely due to a favourable performance of the gem industry, the output in the mining and quarrying sector rose by an impressive 19 per cent in 1987.

TABLE 1.2
Composition and Growth of G.N.P.—1985-1987 at
Constant (1982) Factor Cost Prices

Sector	Amount (Rs. Million)			Growth Rate		
	1985	1986*	1987*	1985	1986	1987
1. Agriculture, Forestry and Fishing	28,366	29,105	27,409	8.6	2.6	- 5.8
1.1 Tea	2,759	2,723	2,750	2.9	- 1.3	1.0
1.2 Rubber	851	856	765	-3.1	0.6	-10.6
1.3 Coconut	3,828	3,935	2,967	52.3	2.8	-24.6
1.4 Paddy	6,783	6,613	5,423	10.0	- 2.5	-18.0
1.5 Other (other Agriculture, Forestry and Fishing)	14,145	14,979	15,504	1.9	5.9	3.5
2. Mining and Quarrying	2,486	2,615	3,112	1.5	5.2	19.0
3. Manufacturing	16,193	17,558	18,748	5.2	8.4	6.8
3.1 Tree Crop Processing	3,222	3,225	3,340	8.0	0.1	3.6
3.2 Other	12,971	14,333	15,408	4.5	10.5	7.5
4. Construction	8,070	8,191	8,338	0.5	1.5	1.8
5. Services	54,455	56,791	58,315	3.9	4.3	2.7
6. G.D.P.	109,570	114,261	115,922	5.0	4.3	1.5
7. Net Factor Income from Abroad	- 2,829	- 2,696	- 2,615	—	—	—
8. G.N.P.	106,741	111,565	113,307	5.3	4.5	1.6

* Provisional

Source: Central Bank of Sri Lanka.

In 1987, the construction sector expanded by 1.8 per cent compared with a lower growth of 1.5 per cent in the previous year. The output in electricity, gas, water and sanitary services increased by 3 per cent in 1987. The modest growth in this sector was largely due to a 18 per cent drop in electricity generation through hydro power, owing to inadequate rainfall in catchment areas. In wholesale and retail trade, the value added rose by 2.8 per cent while in the banking, insurance and real estate sector, there was a higher expansion of 6.1 per cent in value added, largely reflecting the improved performance of the banking sector. Among the other sectors which recorded positive growth in value added in 1987 were ownership of dwellings (1.5 per cent) and other services (2.7 per cent). The expansion in value added in public administration and defence was a modest 3 per cent in 1987, compared with a 19 per cent growth in 1986.

There was a slight moderation in the rate of capital formation in 1987. Gross Domestic Capital Formation (GDCF), inclusive of change in stocks, rose by 8 per cent, as compared with an increase of 10 per cent in 1986. As in the previous year, the more striking contribution to capital formation came from the government sector, where gross capital formation expanded by 17 per cent, although this was lower than the increase of 23 per cent in the previous year. The combined capital formation of private sector and public corporations, which accounted for 76 per cent of the total GDCF, rose by 5.6 per cent in 1987, compared with an increase of 6.4 per cent in the previous year. As a ratio of GDP at market prices, GDCF declined marginally from 23.6 per cent in 1986 to 23.3 per cent in 1987.

Tea production, which suffered a slight set-back in the previous year, increased marginally by 1 per cent to 213 million kgs. in 1987. It was the combined outcome of an increase in the production of mid-grown and low grown teas and a reduction in high grown tea. This was the third consecutive year when the production of high grown teas declined, and the drop in 1987 was 5 per cent. The increase in tea production in 1987 came entirely from the private sector, as the output of the state-owned plantations decreased. The combined output of the Janatha Estates Development Boards (JEDBs) and the Sri Lanka State Plantations Corporations (SLSPCs) dropped by 3 per cent to 123.2 million kgs. in 1987. Continuing with a trend observed since 1981, tea production in the private sector rose by an impressive 10 per cent in 1987.

In contrast to tea, rubber production declined considerably by 11 per cent to 123 million kgs. in 1987—the lowest level on record for the last two decades. Production dropped during the first quarter of the year due to severe drought conditions, while during the third quarter, tapping was interrupted in major producing areas by heavy rains. Both the public sector and the private sector shared in the production decline. The combined output of the JEDBs and SLSPCs (excluding production out of bought latex) decreased by 4 per cent, while the production in the private sector dropped by 13 per cent. The set-back to production in 1987 has been due to both lower yields and a reduction in the area under tapping. While the average yield decreased by 10 per cent to 744 kgs. per hectare, the total area under tapping dropped by 1 per cent to 165,565 hectares—the lowest area recorded for a considerable period of time.

Coconut production, which reached a record level of 3,039 million nuts in 1986, suffered a severe set-back in 1987 registering a decline of 25 per cent to 2,292 million

nuts. This drop in production, which was more pronounced during the second half of the year, was very largely the outcome of prolonged drought conditions in the major coconut growing areas during 1986 and 1987. An additional factor was the lagged effect of lower fertilizer application during 1985 and 1986 when the prices remained highly depressed. Moreover, fertilizer application tends to decline during periods of drought. Reflecting the sharp fall in nut production, the output of all major coconut export products—coconut oil, desiccated coconut (DC) and copra—registered decreases. Consequently, although there was a significant recovery of coconut prices in international markets during 1987, Sri Lanka was not able to reap the full benefits of this price improvement. The exports of coconut kernel products declined by 51 per cent in 1987.

Following the same trends as in coconut, paddy production declined by 18 per cent, to 2.1 million metric tons (102 million bushels) in 1987. This was the second consecutive year when paddy production dropped, and the 1987 production level was the lowest since 1979. The rice equivalent of the total paddy production in 1987, after adjusting for wastage and seed paddy requirements, estimated at 1.3 million metric tons, was sufficient to meet around 80 per cent of the estimated total annual consumption, as against 98 per cent achieved in 1986. As in the case of coconut, the sharp production set-back was mainly due to prolonged drought conditions that prevailed in most major paddy producing areas during the year. The unsettled conditions in the Northern and Eastern Provinces also had a negative effect on production. The production decline was reflected in both Maha 1986/87 and Yala 1987 seasons, where the declines were around 18 per cent in each season.

Under the impact of adverse weather, the gross extent sown under paddy declined by 13 per cent in 1987. The gross extent sown during Maha 1986/87 declined by 9 per cent to 507,830 hectares and in Yala by 20 per cent to 273,396 hectares. Substantial decreases in the extent sown under paddy were recorded in the major paddy producing districts of Kurunegala, Anuradhapura and Trincomalee. Reflecting a high degree of crop failure, the extent harvested decreased by a larger margin of 19 per cent. The total gross extent harvested in Maha, 1986/87 declined by 18 per cent and that of Yala by 20 per cent. The difference between the extent sown and the extent harvested during the cultivation year 1987 amounted to 102,479 hectares or 13 per cent of the gross extent sown. The highest degree of crop failure during both seasons was in the Kurunegala district, which experienced most severe drought conditions.

Another crop which suffered a serious set-back in 1987 was sugar, in which the output declined by 15 per cent to 29,304 metric tons. The drop in production was wholly confined to factories belonging to the Sri Lanka Sugar Corporation (SLSC), where output declined substantially, by about 29 per cent. On the other hand, sugar production in the private sector (Pelwatta Sugar Company) increased by 9 per cent, but the output remained considerably lower than the anticipated target for the year. The output of the SLSC and Pelwatta Sugar Company in 1987 were 15,035 metric tons and 14,269 metric tons, respectively.

In the Minor Food Crops sector, the performance in 1987 had been mixed. The production of a number of crops such as blackgram, greengram, cowpea, maize, gingelly and red onions recorded significant increases. Apparently, when drought makes water

supplies scarce, farmers tend to shift to crops which require less water than paddy. However, among the important minor food crops which recorded decreases in production were potatoes, chillies and Bombay onions.

As in the previous year, fish production is estimated to have recorded an increase of 4 per cent, to reach 190,002 metric tons in 1987. All fishery sectors—coastal fishery, offshore and deep sea fishery and inland fishery—contributed towards this production gain. The private sector continued to contribute the major share of total fish production in the country. According to provisional estimates, milk production in 1987 has increased sharply by 54 per cent to 275 million litres, while egg production has also risen by 22 per cent to 815 million.

The industrial sector, which has shown considerable buoyancy in recent years, continued its growth momentum in 1987. The value of industrial output, which grew by an impressive 12 per cent in real terms in 1986, expanded by a further 8 per cent in 1987. The expansion in industrial output came entirely from private sector industries, which rose by an impressive 15 per cent. In contrast, the value of output in public sector industry declined by 1 per cent largely due to production shortfalls in the Sri Lanka Sugar Corporation (24 per cent), State Distilleries Corporation (21 per cent), the British Ceylon Corporation (16 per cent), Ceylon Ceramics Corporation (7 per cent), Sri Lanka Tyre Corporation (4 per cent) and the National Textile Corporation (3 per cent). There was also only a very marginal growth in the output of the Ceylon Petroleum Corporation, which accounts for a very large share of the total public sector industrial production. The civil disturbances also affected adversely the production of a number of public sector industries. Industrial corporations which recorded significant increases in output during the year were Oils and Fats (89 per cent), State Mining and Mineral Development (34 per cent), State Timber (19 per cent), Sri Lanka Cement (11 per cent) and Ceylon Steel (11 per cent).

In the private sector, the industrial sub-sectors which recorded production increases were textiles and wearing apparel, fabricated metal products, chemicals and non-metallic mineral products. However, the most significant contribution came from the textiles and garments industry, where there were both increased utilization of export quotas, as well as a change in the composition of production toward high value added items. Textiles and garments exports accounted for 65 per cent of the total value of industrial exports in 1987.

Despite continuing civil disturbances in some parts of the country, investment momentum in the industrial sector continued in 1987, on account of attractive incentives. Local Investment Advisory Committees (LIACs) approved 364 projects in 1987, with a total envisaged investment of Rs. 530 million and an employment potential of approximately 14,500 persons. Similarly, the Foreign Investment Advisory Committee (FIAC) approved 41 industrial projects during the year, with an envisaged capital investment of Rs. 672 million and estimated employment of around 5,000 persons. The number of projects approved by the LIAC and FIAC in 1986 were 321 and 41, respectively. The Greater Colombo Economic Commission (GCEC) too approved 31 projects in 1987, compared with 10 projects in 1986. The total investment in these projects is estimated at Rs. 812 million, with an employment potential of 8,970 persons.

In keeping with recent trends, budgetary transfers to industrial corporations remained modest during the year under review. In 1987, such transfers amounted to Rs. 290 million, compared with Rs. 473 million in the previous year. Of the 1987 transfers, capital transfers absorbed Rs. 240 million (83 per cent) and current transfers, Rs. 50 million (17 per cent). As in the last two years, Sri Lanka Sugar Corporation received four fifths of the budgetary transfers.

The developments in the energy sector in 1987 were a reversal of the favourable trends experienced in the previous year. The drastically reduced levels of water in the reservoirs due to long spells of drought in the catchment areas, severely restricted the generation of hydro power. Thus, the country's power requirements had to be met by an increased dependance on thermal power, involving a heavy consumption of diesel and heavy fuel. In fact, with increasing constraints on electricity generation, island-wide three and half hour power cuts had to be imposed between August and October, with adverse effects on economic activity. Meanwhile, there was an increase in the price of petroleum products (including crude oil) in the international markets. Hence, the outlay on petroleum imports rose considerably, adding pressure on the balance of payments. The total oil import bill rose by 20 per cent in SDR terms, accounting for 14 per cent of total imports, as against 11 per cent in the previous year.

The rate of inflation, as measured by the growth in retail prices, was marginally lower in 1987 than in the previous year. The annual average rate of increase of the Colombo Consumers' Price Index (CCPI) was 7.7 per cent, as compared to an 8.0 per cent rise in 1986. However, on a point to point basis, i.e. December 1987 over December 1986, the index increased by 10.2 per cent, reflecting a significant upsurge in prices during closing months of 1987. These changes seem to suggest the prevalence of considerable price pressure in the economy towards the end of 1987. Prices rose very slowly during the first quarter of 1987 and accelerated moderately in the second quarter. While seasonal factors contributed toward dampening the rate of price increase in the third quarter, prices rose at a sharply accelerated pace during the fourth quarter.

Many factors contributed toward pushing consumer prices up during 1987, which was mostly evident in the food category. Adverse weather conditions in major producing areas and the unsettled conditions in the North and the East dampened the production of food items such as rice and dried chillies, creating occasional shortages and price increases. The severe set-back to coconut production caused prices to rise sharply. Domestic sugar prices rose as a consequence of price increases in international markets, while the price of beef also increased. For manufactured goods, the producers tended to adjust prices in line with rising costs of raw materials and wages. At the same time, higher excise duties resulted in raising the tobacco and alcohol prices, while prices of export commodities remained high due to better prices in international markets and the exchange rate depreciation. The depreciation of the Rupee pushed import prices up, in terms of domestic currency, an unavoidable result of the process of safeguarding the external balance. On the demand side, there was some relaxation of monetary policy resulting in an acceleration in the growth of bank credit, particularly during the last quarter of the year. The Budget deficit continued to be expansionary. These developments tended to maintain aggregate demand high at a time when the domestic supply situation came under strain during the last quarter of the year.

In 1987, the increase in producer prices was much sharper than the rise in consumer prices. The Wholesale Price Index (WPI) which recorded successive decreases of 15 per cent and 3 per cent in 1985 and 1986, respectively rose by 13 per cent in 1987. On a point to point basis, i.e. December 1987 over December 1986, the index increased by 13 per cent. As in the case of the CCPI, the index recorded sharp increases in the last quarter of the year. The main underlying factor for the sharp increase in the WPI was the improvement in the prices of export commodities, which have a high weightage in this index.

In 1987, while wage rate index of government servants remained static at 1986 January level, several categories of workers in the organised private sector received wage increases. In nominal terms, the Minimum Wage Rate Index for workers in trades covered by the Wages Boards increased by an average of 6.3 per cent, compared with a rise of 5.4 per cent in the previous year. However, against the background of a sharper increase in the price level, their real wages deteriorated by 1.4 per cent during the year. The Minimum Wage Rate Index of workers in agriculture moved up by 4.9 per cent in 1987 but their real wages deteriorated by 2.6 per cent. As in the previous year, workers in industry and commerce received the highest increase of 14.3 per cent in nominal wages, improving their real wages by 6.0 per cent during the year.

Employment in the private sector increased in 1987 while that of the public sector decreased marginally, from the levels in the previous year. According to provisional estimates, total employment in the public sector declined marginally by 1.5 per cent to 1,194,000 at the end of 1987. Of the total employed in the public sector, approximately 749,000 were in semi-government institutions, while the balance 445,000 were in the government sector proper. The reduction in employment in the public sector was the combined effect of an increase in employment in the government sector proper and a reduction in semi-government institutions. On a sector-wise basis, areas in the government sector where employment increased in 1987 were defence services, education, health and public administration.

Following the trend observed in recent years, employment in semi-government institutions recorded a moderate decline of 2.4 per cent, to an estimated total of 749,000 at the end of 1987. Within the semi-government sector, however, employment in energy related corporations such as Petroleum Corporation and the Government Owned Business Undertaking of Gas and Water Company Limited, and in certain transport boards increased, while that of State Plantation Corporations and construction-related corporations declined.

On the basis of the records of the Employees' Provident Fund and other approved provident funds, employment in the organised private sector has been estimated to be around 330,000 at the end of 1987, showing a marginal growth of 1 per cent. Continuing the favourable trend observed in recent years, employment in enterprises coming under the Greater Colombo Economic Commission (GCEC) increased during the year under review. As at the end of 1987, the total number of persons employed in the GCEC enterprises stood at 50,744, registering an increase of 12.6 per cent over the level in the previous year.

Despite a set-back to output in the plantation agricultural sector, the developments in the external trade sector were not altogether unfavourable in 1987. While the value of exports rose by 4 per cent in SDR terms, expenditure on imports dropped by 4 per cent, over 1986. Consequently, the deficit on trade account decreased by 18 per cent in 1987. Yet, the trade deficit in 1987 was large enough to exert pressure on the external assets, in the context of reduced inflows of capital.

The improved performance of the export sector in 1987 was largely due to higher earnings from industrial exports and gems. Although the prices of tea, rubber and coconut products increased in real terms, earnings from agricultural exports declined by 5 per cent in SDR terms, owing to reduced export volumes. On the import front, there was a significant rise in the value of petroleum imports due to both volume and price increases. However, the value of consumption goods and investment goods imports dropped in real terms, resulting in an overall reduction in value in SDR terms.

In terms of adjusted customs data, the value of exports is estimated at Rs. 41,133 million (SDR 1,080 million) in 1987, compared with Rs. 34,072 million (SDR 1,036 million) in 1986, recording an increase of 21 per cent in Rupee terms and 4 per cent in SDR terms. Considered against decreases both in Rupee and SDR terms experienced in 1985 and 1986, this was a welcome development. The main impetus to better export performance in 1987 came from industrial and mineral exports. The value of industrial exports increased from Rs. 15,878 million (SDR 483 million) in 1986 to Rs. 20,004 million (SDR 525 million) in 1987, while that of mineral exports rose from Rs. 1,182 million (SDR 36 million) to Rs. 1,758 million (SDR 46 million). The earnings from agricultural exports declined in SDR terms owing to a sharp drop in the export volumes of three major agricultural commodities which was the disappointing feature of Sri Lanka's export performance in 1987. The export volume of tea declined by 3 per cent to 201 million kgs. in 1987, while the volume of rubber exports fell by 4 per cent to 106 million kgs. The overall export volume of coconut kernel products declined from an equivalent of 1105 million nuts in 1986 to 538 million nuts in 1987. In view of these reductions, the country failed to reap the full benefits of the increase in the prices of these commodities in international markets. In SDR terms, the earnings from tea decreased marginally, from rubber by 4 per cent and from coconut by 23 per cent. Overall earnings from agricultural exports decreased by 5 per cent, falling from SDR 479 million in 1986 to SDR 458 million in 1987, despite an improvement in prices.

A noteworthy feature in the export front in recent years had been the progressive expansion in industrial exports resulting in this category of exports assuming the dominant position by 1986. In 1987, earnings from industrial exports rose by 26 per cent (9 per cent in SDR terms), increasing from Rs. 15,878 million (SDR 483 million) in 1986 to Rs. 20,004 million (SDR 525 million) in 1987. With this increase, the share of industrial exports in total exports rose to 49 per cent, from 47 per cent in the previous year. The growth in industrial exports was largely reflected in textile and garment exports, which rose by a commendable 34 per cent (16 per cent in SDR terms), from Rs. 9,629 million (SDR 293 million) in 1986 to Rs. 12,897 million (SDR 339 million) in 1987. Another export item which displayed dynamism in 1987 was gem exports,

their value rising by 92 per cent (65 per cent in SDR terms) from Rs. 755 million (SDR 23 million) in 1986 to Rs. 1,447 million (SDR 38 million) in 1987. The growth in earnings was reflected in both higher volumes and favourable prices. While the export volume rose from 4.9 million carat in 1986 to 5.4 million carat in 1987 or by 10 per cent, the average f.o.b. price increased by 73 per cent from Rs. 154 per carat to Rs. 267 per carat over the same period. The share of gem exports in total exports was 3.5 per cent in 1987, compared with 2.2 per cent in 1986.

In terms of adjusted customs data, the expenditure on imports amounted to Rs. 60,517 million (SDR 1,588 million) in 1987, compared with Rs. 54,559 million (SDR 1,658 million) in 1986. Although this reflects an increase of 11 per cent in Rupee terms, it was a decrease of 4 per cent in SDR terms. The decrease was largely reflected in the imports of consumer goods and investment goods. The outlay on consumer goods imports declined by 3 per cent in SDR terms to SDR 362 million, though in Rupee terms it increased by 13 per cent to Rs. 13,804 million. The decrease in SDR terms was reflected in all categories of consumer goods imports. In particular, the imports of food and drink dropped by 5 per cent to SDR 196 million, in large part on account of a sharp fall in rice imports. However, within this category the outlay on sugar imports rose by 17 per cent, from SDR 54 million in 1986 to SDR 63 million in 1987, owing to increases in both price and volume.

The expenditure on investment goods imports in 1987 amounted to Rs. 11,332 million (SDR 297 million), showing a decrease of 7 per cent in SDR terms, but a moderate increase of 7 per cent in Rupee terms. The imports of building materials and transport equipment dropped sharply in SDR terms by 33 per cent and 16 per cent, respectively, while the value of machinery and equipment imports also dropped marginally by 2 per cent.

In contrast to consumer and investment goods imports, the expenditure on intermediate goods imports at Rs. 34,619 million (SDR 909 million) recorded increases in both Rupee and SDR terms. The increase in Rupee terms was 21 per cent and in SDR terms 4 per cent. This was largely on account of petroleum imports, which rose from Rs. 6,293 million (SDR 191 million) in 1986 to Rs. 8,716 million (SDR 229 million) in 1987, as a result of price and volume increases. While the volume of crude oil imports rose from 12.1 million barrels in 1986 to 13.1 million barrels in 1987, the average import price increased from SDR 13.3 per barrel to SDR 14.3 per barrel. Another noteworthy feature was the increase in textiles and clothing imports, largely to meet the raw material requirements of the garment industry. The value of these imports rose from Rs. 6,353 million (SDR 193 million) in 1986 to Rs. 8,086 million (SDR 212 million) in 1987.

In terms of both trade and current account balances, Sri Lanka's balance of payments recorded some improvement in 1987. The deficit on merchandise trade account declined from SDR 649 million in 1986 to SDR 531 million in 1987. Moving in the same direction, the current account deficit, decreased from SDR 363 million to SDR 266 million, and as a ratio of GDP, declined from 6.6 per cent in 1986 to 5.2 per cent in 1987, indicating a slight easing of pressure on the balance of payments. However, the overall balance continued to be in deficit, to the tune of SDR 72 million in 1987. This was the third consecutive year when the overall balance was in deficit, leading to a

drawing down of external reserves. The cumulative deficit in the overall balance during the last three years was in the region of SDR 257 million.

The out-turn in the services account of the balance of payments deteriorated further in 1987, the deficit increasing from SDR 109 million in 1986 to SDR 114 million in 1987, entirely due to a sharp decline in tourist earnings. Tourist arrivals declined by 21 per cent in 1987 and receipts from tourism dropped from SDR 71 million in 1986 to SDR 48 million in 1987—a decrease of 32 per cent.

There were, however, some favourable developments too in the services account of the balance of payments in 1987. The port, transportation and insurance category, which had been in deficit in the last two years, generated a surplus of SDR 8 million in 1987, owing to increased receipts from the Port and a reduction in charter fees and payments for fuel by Air Lanka.

TABLE 1.3
Summary of Balance of Payments 1984-1987

Rs. Million (SDR Million in brackets)

Items	1984(a)	1985(a)	1986(a)	1987(b)
Merchandise (Net)	.. - 850 (- 453)	- 19,801 (- 711)	- 21,390 (- 649)	- 20,743 (- 531)
Non-Factor Services (Net)	.. 1,666 (64)	- 201 (- 8)	255 (8)	79 (1)
Factor Services (Net)	.. - 3,401 (- 130)	- 3,445 (- 125)	- 3,871 (- 117)	- 4,336 (- 115)
Private Transfers (Net)	.. 7,031 (270)	7,212 (262)	7,982 (242)	9,161 (240)
Official Transfers (Net)	.. 5,154 (198)	4,828 (172)	5,114 (153)	5,302 (139)
Current Account Balance	.. - 1,400 (- 51)	- 11,408 (- 410)	- 11,910 (- 363)	- 10,537 (- 266)
Overall Balance	.. + 7,062 (+ 297)	- 1,060 (- 110)	- 2,124 (- 74)	- 1,801 (- 72)

Some Key Indicators

Terms of Trade (1981=100)	.. 140	115	111	114
Net Petroleum Imports	.. 7,394 (284)	7,109 (257)	3,935 (120)	6,124 (160)
Current Account Deficit as a percentage of G.D.P.	.. 0.9	6.9	6.6	5.2
Gross International Reserves	.. 18,942 (735)	18,367 (611)	17,152 (492)	18,134 (415)
International Reserves in Months of Imports (c)	.. 4.4	4.4	3.7	2.9

(a) Revised.

(b) Provisional.

(c) Projected for the following year's imports in SDR terms.

Source: Central Bank of Sri Lanka.

Another noteworthy development was a reduction in the deficit on account of investment income, largely on account of a softening of interest rates in international markets. Interest payments and other service charges on foreign loans, including IMF credits, registered a marginal decline, from SDR 159 million in 1986 to SDR 156 million in 1987. The remittances of profits and dividends were also lower in 1987.

In recent years, foreign exchange inflow on account of private remittances had become a major source of balance of payment support but some moderation in these remittances was anticipated following the contraction of oil dependent West Asian economies. Thus, such remittances which declined by 6 per cent in SDR terms in 1986 recorded a further marginal decrease in 1987, declining by SDR 1 million to SDR 268 million. However, in Rupee terms such remittances increased by 16 per cent reaching Rs. 10,255 million in 1987. In 1987, official transfers consisting of project and commodity grants declined for the second consecutive year. Such transfers which decreased from SDR 172 million in 1985 to SDR 153 million in 1986, declined further to SDR 139 million in 1987. The net outcome of these developments was a decline of 4 per cent in total net transfer receipts, both private and official in SDR terms.

The net receipts on account of transfers were sufficient to finance 59 per cent of the deficit on goods and services in 1987, as compared with 52 per cent in 1986, thus contributing to a lower current account deficit than in the previous year. The deficit in the current account in 1987 was estimated at SDR 266 million, as against a deficit of SDR 363 million in 1986, reflecting a 27 per cent reduction. This is the second consecutive year when the current account balance recorded an improvement, but still remaining at a level to cause concern. As a ratio of GDP, the current account deficit declined from 6.9 per cent in 1985 to 6.6 per cent in 1986 and to 5.2 per cent in 1987.

The inflows of non-monetary capital, which had been on a downward path since 1982, suffered a further set-back in 1987 when such inflows declined by 33 per cent. This was largely due to a decline in official capital flows, which fell by 42 per cent. In 1987, the net inflow of official capital was SDR 146 million, as compared with SDR 251 million in 1986. The decrease was evident in both project as well as commodity loan disbursements. On the other hand, the net inflows of private capital rose from SDR 28 million in 1986 to SDR 41 million in 1987.

As net inflows of non-monetary capital were sufficient to finance only 70 per cent of the current account deficit, there was an overall deficit of SDR 72 million, which had to be financed by drawing on external assets. Thus, gross external assets declined by 15 per cent in 1987. This was the third consecutive year when the country's gross external assets declined, and the respective decreases in 1985 and 1986 were 17 per cent and 19 per cent. Gross external assets at the end of 1987 stood at SDR 415 million (Rs. 18,134 million), as compared with SDR 492 million (Rs. 17,152 million) at the end of 1986. The level of gross external assets as at the end of 1987 was sufficient to finance about three months' imports projected for 1988.

Against a backdrop of great volatility of exchange rates the world over, when there was an appreciation of most international currencies against the US Dollar, Sri Lanka Rupee depreciated in nominal terms against most major currencies in 1987. The Rupee

depreciated by 28 per cent against the Japanese Yen, 27 per cent against the Pound Sterling, 24 per cent against the Deutsche Mark and 22 per cent against the French Franc. The Rupee depreciated by 10 per cent against the Indian Rupee and 7 per cent against the US Dollar. Largely reflecting the depreciation of the US Dollar against the SDR, the Rupee depreciated by 20 per cent against the SDR in 1987. The Nominal Effective Exchange Rate (NEER) of the Sri Lanka Rupee measured by a basket of currencies of Sri Lanka trading partners, depreciated by 20 per cent in 1987 while the Real Effective Exchange Rate, i.e. the NEER adjusted for inflation differentials between Sri Lanka and her trading partners, depreciated by 17 per cent.

The Annual Report for 1986 drew attention to the fact that the rate of growth of external debt had been a matter of concern in recent years. In 1987, Sri Lanka's total outstanding external debt, including short-term loans, trade credits and Central Bank borrowings, increased from Rs. 116,429 million (SDR 3,359 million) in 1986 to Rs. 144,531 million (SDR 3,361 million) in 1987. Thus, while the external debt had expanded by a significant margin in Rupee terms (24 per cent) in 1987, the increase in SDR terms had been very marginal. In large part, the sharp increase in the external debt in Rupee terms arose from the depreciation of the Rupee. As a result, the ratio of outstanding debt to GDP rose from 62 per cent in 1986 to 64 per cent in 1987. External obligations to the IMF decreased for the third consecutive year, decreasing from SDR 234 million in 1986 to SDR 165 million in 1987, following large repurchases (i.e. repayments) made during the year.

Total service payments on the external debt, which include amortization payments on the medium and long-term loans and interest payments on all foreign loans, increased from Rs. 11,658 million (SDR 357 million) in 1986 to Rs. 14,867 million (SDR 391 million) in 1987. This is because the decline in the value of the U.S. Dollar and the downward trend in interest rates helped to alleviate the real costs of servicing the debt. Total amortization payments, including repurchases of IMF drawings, increased by 20 per cent, from Rs. 6,940 million (SDR 213 million) in 1986 to Rs. 9,743 million (SDR 256 million) in 1987. However, owing to a softening of international interest rates, interest payments decreased by 5.8 per cent to SDR 135 million in 1987. Reflecting the increase in amortization payments, the debt service ratio, i.e. the total debt service payments as a ratio of exports of goods and services, rose from 26.4 per cent in 1986 to 28.5 per cent in 1987. Excluding IMF transactions, the ratio was 22 per cent in 1987, while the overall debt service ratio, i.e. total service payments as a ratio of current account receipts, excluding official transfers, amounted to 23.8 per cent, as compared with 22 per cent in the previous year.

The balance of payments developments in 1987 demonstrates the continuing weakness of Sri Lanka's external sector which, in turn, involve serious implications on overall economic performance. On the export front, the country was deprived the full benefits of improved prices in respect of her major primary commodity exports, due to reductions in volumes following the production short-falls. The tourist industry badly affected by the adverse publicity arising from civil disturbances, took a further beating in 1987, its earnings recording the lowest level since 1980. In the case of imports, the rise in crude oil prices in international markets contributed to keep the overall import bill at high levels while the growing external debt commitments continue to exert

pressure on the payments side. Under the impact of these developments, the balance of payments position remained weak, with continuing pressure on the exchange rate and a further depletion of external assets.

In 1987, government financial operations continued to display the stresses under which the fiscal system of Sri Lanka has been operating in recent years. According to provisional data, the budget deficit (after grants) as a ratio of GDP declined from 10.1 per cent in 1986 to 8.3 per cent in 1987. Although this was evidently an improvement in the overall budgetary position, in the final outcome this was not so. Under the impact of a faster rate of growth in current expenditure than in government revenue, the current account surplus narrowed, declining from 1.8 per cent of GDP in 1986 to 1.7 per cent in 1987. At the same time, the expansionary deficit, i.e., that part of the budget deficit which had to be financed out of bank credit, increased from 1.7 per cent of GDP to 1.8 per cent. These developments suggest the existence of continuing fiscal pressure, which has been a major source of economic instability for many years.

Total government revenue at Rs. 42,155 million, recorded an increase of 13 per cent; and as a percentage of GDP, revenue increased from 20.8 per cent in 1986 to 21.4 per cent in 1987. Tax revenue as a percentage of GDP also recorded an improvement, from 17.4 per cent in 1986 to 17.9 per cent in 1987, demonstrating that the rate of growth in government revenue had more than kept pace with the rate of growth of income. Tax revenue contributed 83 per cent of the total revenue in 1987, the same ratio as in the previous year.

On the side of expenditure, current expenditure totalling Rs. 38,713 million registered an increase of 14 per cent, and as a percentage of GDP, rose from 18.9 per cent in 1986 to 19.7 per cent in 1987. Government's outlay on goods and services of Rs. 17,640 million accounted for nearly half of this expenditure. Interest payments on government debt represented 26 per cent, while current transfers to public corporations, institutions and households, accounted for 28 per cent.

Total budgetary resources mobilised by way of revenue and grants were Rs. 46,679 million, an increase of 14 per cent in 1987. On the other hand, largely on account of a reduction of 4 per cent in capital expenditure, the total expenditure at Rs. 63,059 million registered an increase of only 7 per cent. The resulting budget deficit (after grants) of Rs. 16,380 million was lower than the deficit in the previous year, a commendable achievement. As a proportion of GDP, the overall deficit declined from 10.1 per cent in 1986 to 8.3 per cent in 1987. The budget deficit before grants as a ratio of GDP also dropped from 12.2 per cent to 10.6 per cent over the two year period.

Although the budget deficit was a considerable improvement from the previous year, the resources for financing the deficit were less forthcoming in 1987. The resources available from foreign loans were Rs. 5,716 million which was 37 per cent lower than in the previous year. Thus, foreign loans which financed nearly one half of the budget deficit in recent years, contributed only a third in 1987. The resources available from domestic non-bank sources of Rs. 6,399 million also showed a decline of 5 per cent. Hence, a larger volume of resources had to be utilised from banking sources than in the previous year for financing the budget deficit in 1987. Resources obtained from the banking system was Rs. 3,541 million representing 1.8 per cent of the GDP in 1987. The expansionary deficit in 1986 was 1.7 per cent of GDP.

TABLE 1.4
Summary of Government Fiscal Operations

Rs. Million

Item	1983	1984	1985	1986	1987 Provisional
Total Revenue and Grants ..	26,790	37,354	39,556	40,991	46,679
Total Revenue ..	23,317	34,061	36,249	37,238	42,155
Tax Revenue ..	19,912	29,939	30,442	31,272	35,127
Non-Tax Revenue ..	3,405	4,122	5,807	5,966	7,028
Grants ..	3,473	3,293	3,307	3,753	4,524
Expenditure and Lending Minus Repayments. ..	39,637	47,837	55,234	59,193	63,059
Current ..	22,002	24,630	32,645	33,966	38,713
Capital ..	15,863	19,915	21,530	23,236	22,969
Lending Minus Repayments ..	1,772	3,292	1,059	1,991	1,377
Current Account Surplus/Deficit (-) ..	1,315	9,431	3,604	3,272	3,442
Budget Deficit (before grants) ..	-16,320	-13,776	-18,985	-21,956	-20,904
Budget Deficit (after grants) ..	-12,847	-10,483	-15,678	-18,203	-16,380
Financing ..	12,845	10,483	15,678	18,204	16,380
Foreign Borrowings ..	6,312	6,492	7,109	9,061	5,716
Domestic Borrowings ..	6,533	3,991	8,569	9,143	10,664
Non Market Borrowings ..	1,977	951	-1,801	-669	724
Market Borrowings ..	4,556	3,040	10,370	9,812	9,940
Non Bank ..	4,082	5,135	5,659	6,765	6,399
Bank ..	474	-2,095	4,711	3,047	3,541

(as a percentage of GDP)

Total Revenue and Grants ..	22.0	24.3	24.4	22.8	23.7
Total Revenue ..	19.2	22.2	22.3	20.8	21.4
Tax Revenue ..	16.4	19.5	18.7	17.4	17.9
Non-Tax Revenue ..	2.8	2.7	3.6	3.3	3.6
Grants ..	2.9	2.1	2.0	2.1	2.3
Expenditure and Lending Minus Repayments. ..	32.6	31.1	34.0	33.0	32.1
Current ..	18.1	16.0	20.1	18.9	19.7
Capital ..	13.0	13.0	13.3	13.0	11.7
Lending Minus Repayments ..	1.5	2.1	0.7	1.1	0.7
Current Account Surplus/Deficit (-) ..	1.1	6.1	2.2	1.8	1.7
Budget Deficit (before grants) ..	-13.4	-9.0	-11.7	-12.2	-10.6
Budget Deficit (after grants) ..	-10.6	-6.8	-9.7	-10.1	-8.3
Financing ..	10.6	6.8	9.7	10.1	8.3
Foreign Borrowings ..	5.2	4.2	4.4	5.1	2.9
Domestic Borrowings ..	5.4	2.6	5.3	5.1	5.4
Non Market Borrowings ..	1.6	0.6	-1.1	-0.4	0.4
Market Borrowings ..	3.7	2.0	6.4	5.5	5.1
Non Bank ..	3.4	3.3	3.5	3.8	3.3
Bank ..	0.4	-1.4	2.9	1.7	1.8

Source : Central Bank of Sri Lanka.

The overall fiscal scenario in 1987 seems to suggest the need for continued efforts at mobilising budgetary resources and containing expenditure for the sake of greater economic stability. Although there was improved performance on the revenue front, the total revenue collection increasing by 13 per cent, current expenditure recorded a slightly higher increase of 14 per cent. While the flow of foreign grants for budgetary purposes increased, there was a sharp decline in the utilisation of long-term loans. There was also a decrease in the volume of resources available from domestic market sources.

These developments resulted in an enlargement of the expansionary deficit which had been a major contributory factor for the continuing pressure on the money supply, prices and balance of payments in recent years. Although it had been possible to moderate to some extent the adverse consequences of expansionary financing in the short-run by adopting restrictive monetary policies, in the long-run, excessive monetary restraint can prove to be counter-productive. Furthermore, the increases in service payments on the government debt continued to put an additional stress on the country's fiscal system. These developments would suggest the need for concerted efforts at fiscal discipline so as to strike a closer balance between the availability of resources and the expenditure commitments.

In the context of strong growth in domestic credit and a sharp revival in the expansion of quasi money, the year 1987 witnessed a considerable acceleration in the growth of monetary aggregates. Despite the sharp growth in credit, the commercial banking system remained liquid enabling considerable investments to be made in short-term government paper (Treasury bills). In this background and assisted by a further significant relaxation of the reserve requirements by the Central Bank, interest rates tended to decline, though modestly. The Central Bank which issued its own securities under Section 91 of the Monetary Law Act during 1985 and 1986 to mop-up excess liquidity, relied more on an activation of the Treasury bill market for this purpose in 1987. Toward this, several measures were taken to give greater market orientation to the Treasury bill market. The monetary policy was slightly eased with a view to stimulating economic activity through greater availability of credit at moderate cost. Market forces were encouraged to play a greater role in the determination of interest rates, particularly at the short-end of the market. Refinance facilities of the Central Bank were further enhanced during the year, for promoting activities in productive sectors of the economy.

The acceleration in the growth of money supply during 1987 was reflected in both monetary aggregates. The narrowly defined money supply (M_1) consisting of currency and demand deposits held by the public, expanded by Rs. 3,904 million or 18 per cent, compared with an increase of 13 per cent in 1986. Meanwhile, the broad money supply (M_2), defined to include M_1 plus time and savings deposits held by the public with commercial banks (quasi money), recorded an increase of Rs. 7,475 million or 15 per cent, compared with a growth of Rs. 2,451 million or 5 per cent in the previous year. The increase in broad money reflects a strong revival in the growth of quasi money, which expanded by Rs. 3,571 million or 12 per cent in 1987, compared with a meagre growth of Rs. 33 million in 1986.

In contrast to the experience in the previous year when the expansion in M_1 was heavily concentrated in currency held by the public, in 1987, the currency component rose by Rs. 1,925 million or 17 per cent, while the demand deposit component recorded an increase of Rs. 1,979 million or 21 per cent. The share of deposits in M_1 which had been hovering around 50 per cent for a considerable length of time, started declining since 1983, reaching 45 per cent at the end of 1986. This development was attributable to the disruption of normal banking services in some parts of the country due to the civil unrest. In 1987, there was a reversal of this trend to 46 per cent, which though marginal, can be considered a welcome development.

A noteworthy feature of monetary developments during 1987 was the sharp resurgence in growth in quasi money. In sharp contrast to a negligible increase of Rs. 33

million in 1986, quasi money grew by Rs. 3,571 million or 12 per cent in 1987. The growth in quasi money in 1985 was 11 per cent. Thus, the indications are that after an unusual dip in 1986, the growth of quasi money assumed normal proportions reflecting the re-emergence of bank deposits as an attractive investment outlet. The growth in quasi money came mainly from other private sector constituents (OPSC), i.e. private sector proper, whose time and savings deposits rose by Rs. 3,384 million or 14 per cent. In comparison, time and savings deposits of government corporations increased by a meagre Rs. 119 million and those of co-operative institutions by Rs. 69 million. Incidentally, more than half of the growth in quasi money of the OPSC occurred during the last quarter of the year. Relatively better export prices and the narrowing of the gap between the deposit rates of commercial banks and finance companies were the principal contributory factors for this development.

Reflecting the continuing weakness of the country's balance of payments, the operations of the external sector were contractionary on the monetary aggregates for the third consecutive year in 1987. External banking assets (net) declined by Rs. 443 million or 5 per cent during the year. The decreases in these assets in 1985 and 1986 were Rs. 691 million or 7 per cent and Rs. 414 million or 4 per cent, respectively. Although the balance of payments out-turn in 1987 was a marginal improvement from 1986, both trade and current accounts recording lower deficits, the overall balance remained in deficit to the tune of SDR 72 million, and was financed by drawing on external assets. The continuing decline in external banking assets since 1984 reflect the vulnerability of Sri Lanka's external sector to both domestic and external pressures, which underscores the importance of maintaining stability to promote the development of a strong external sector.

As the external sector was contractionary on the money supply, it was the sharp growth of domestic credit that pushed the monetary aggregates up in 1987. The domestic credit expansion (DCE) in 1987 was Rs. 11,457 million or 18 per cent, which was a significant bounce from the expansion of Rs. 4,883 million or 8 per cent in 1986. The acceleration in the DCE in 1987 was reflected in both net credit to Government (NCG) and gross credit to private sector (GCPS). In all, the NCG from the banking system increased by Rs. 4,502 million or 20 per cent in 1987, as compared with a growth of Rs. 2,198 million or 11 per cent in the previous year. At the same time, GCPS from the commercial banks rose by Rs. 6,955 million or 17 per cent, in comparison to a much lower increase of Rs. 2,684 million or 7 per cent a year ago.

The continued recourse to bank credit on the part of the Government was a matter for concern. The growth in NCG resulted in an increase in its share in domestic credit from 35 per cent in 1986 to 36 per cent in 1987. It must, however, be stated that the increase in NCG directly attributable to budgetary operations during the year was slightly lower at Rs. 3,819 million, as the NCG included a special loan of Rs. 683 million from the Central Bank to Government for meeting Sri Lanka's obligations to the IMF consequent upon successive revaluations of liabilities to the Fund. Yet, the level of bank credit utilised by the Government in 1987 for budgetary purposes is considerable and points to a need for a firm resolve to achieve greater fiscal discipline in the coming years.

TABLE 1.5
Monetary Magnitudes 1983- 1987

Rs. Million

Item	1983	1984	1985	1986	1987
Change in Domestic Credit ..	6,895	633	9,300	4,883	11,457
Increase in Net Credit to Government ...	383	-2,979	5,793	2,198	4,502
Increase in Credit to Government Corporations ...	-292	-237	290	301	2,627
Increase in Credit to Co-operatives ...	635	-255	-263	120	-301
Increase in Credit to Other Private Sector ...	6,170	4,104	3,480	2,263	4,629
Change in Net External Banking Assets ...	815	6,777	-691	-414	-443
Change in Total Assets/Liabilities ...	7,710	7,410	8,609	4,468	11,014
Increase in Broad Money Supply (M₂) ...	6,747	6,170	4,982	2,451	7,475
Increase in Other Liabilities (Net) ...	963	1,240	3,627	2,018	3,539

Percentage Increases in Monetary Magnitudes

Percentage increase in Total Domestic Credit	16.3	1.3	18.6	8.2	17.9
Percentage increase in Total Assets and Liabilities	17.2	14.1	14.4	6.5	15.1
Government as percentage of Total Domestic Credit Increase ...	5.6	-470.4	62.3	45.0	39.3
Non-Government as percentage of Total Domestic Credit Increase ...	94.4	570.4	37.7	55.0	60.7
Percentage Increase in—					
Broad Money Supply (M ₂) ...	22.1	16.6	11.4	5.1	14.7
Narrow Money Supply (M ₁) ...	25.4	14.1	11.5	12.9	18.4

Source: Central Bank of Sri Lanka.

Although the growth in NCG in 1987 can be considered excessive, there was one mitigating factor in that commercial banks made the largest contribution to the expansion in NCG mainly by way of increased investments in Treasury bills. Net credit to government from commercial banks rose by Rs. 3,035 million during the year. In comparison, the increase in NCG from the Central Bank during 1987 was Rs. 1,468 million, which included a special loan of Rs. 683 million on account of IMF transactions. The improvement in their liquidity position, particularly following the reduction of the statutory reserve ratios in August, 1987 enabled the commercial banks to invest a larger volume of resources in Treasury bills.

A salient feature of the developments in the credit scene from a development point of view had been a sharp recovery in the demand for credit from the private sector. In 1987, gross credit to private sector comprising government corporations, co-operative institutions and other private sector constituents (OPSC) rose by Rs. 6,955 million or 17 per cent, as compared with an increase of Rs. 2,684 million or 7 per cent in 1986. The overwhelmingly larger share of the growth in GCPS had been in respect of the OPSC. As against an increase of Rs. 2,263 million or 7 per cent in 1986, commercial bank credit to OPSC expanded by Rs. 4,629 million or 13 per cent in 1987. The latter accounted for approximately two-thirds of the growth in GCPS during the year. Increased demand for export credit associated with relatively favourable prices and the increased utilisation of credit for imports and related trading activities, particularly in the context of the depreciation of the Sri Lanka Rupee, kept up the level of bank credit to OPSC during the year.

In 1987, commercial bank credit to government corporations increased substantially by Rs. 2,627 million or 55 per cent, in comparison to marginal increases of Rs. 301 million or 7 per cent in 1986 and Rs. 290 million or 7 per cent in 1985. The two plantations corporations, Sri Lanka State Plantations Corporation (SLSPC) and Janatha Estates Development Board (JEDB), which resorted to considerable bank borrowings in the previous year, again had heavy recourse to bank credit in 1987. However, the borrowings in 1987 were on account of the implementation of the Medium Term Investment Programme (MTIP) for the development of state owned plantations, rather than for overcoming liquidity problems. The Ceylon Petroleum Corporation (CPC) utilised increased credit because of an upward movement in crude oil prices, and also because it needed to build up stocks of finished products to meet the demand during the closure of the refinery for maintenance purposes. Another corporation which enhanced its access to bank credit in 1987 was the Co-operative Wholesale Establishment (CWE) and this was for the bulk importation of essential food items. Several corporations, however, reduced their reliance on bank credit during the year. Among them were the Ceylon Steel Corporation, Ceylon Plywoods Corporation, Sri Lanka Cement Corporation and the Veyangoda Textile Mills.

Bank credit to Co-operative institutions which increased by Rs. 120 million or 9 per cent in 1986, dropped significantly by Rs. 301 million or 21 per cent during 1987. The reduction in lending both for the cultivation and marketing of agricultural products in areas affected by drought conditions was the main contributory factor.

The gradual downward movement in interest rates, which began in the previous year continued during 1987 though at a modest pace, with reductions in rates evident in certain categories of advances and deposits. The excess liquidity in the financial system, particularly during the first half of the year, facilitated this movement to some extent. Perhaps, the reductions would have been far more pronounced if not for the fact that the National Savings Bank (NSB), the prime mobiliser of small deposits, maintained a fixed deposit interest rate of 13 per cent per annum throughout the year.

Finance companies continued to offer competitive rates on term deposits and Certificates of Deposits. For instance, during the last quarter of the year, the 1-year deposits rate offered by some major finance companies ranged between 16 to 20 per cent per annum, as against the interest rates offered by the commercial banks ranging between 8.5 to 14 per cent per annum. However, as from December, 1987 the deposits rates of finance companies became subject to certain ceilings in terms of the directions issued by the Central Bank under the Control of Finance Companies Act.

The short-term money market rates tended to decline further during the year under review. Market forces played a greater role in determining the rates in the primary market for Treasury bills. With a view to attracting investors to the primary Treasury bill market, the discount rate (yield) in the secondary Treasury bill market was substantially lowered. In the first 8 months of the year, the rates in the primary Treasury bill market varied between 8 to 12 per cent per annum. However, since then, the rates fluctuated within a narrower band of 8 to 11 per cent, conforming to the downward trend in the overall interest rate structure.

In 1987, the commercial banking system was better placed to make downward adjustments in interest rates to reflect market conditions. In the first instance, the two state banks lowered their rates offered on various types of deposits. Perhaps the greatest motivation to commercial banks for effecting downward adjustments in interest rates came from certain policy changes introduced by the Central Bank. In the first instance, Bank rate was reduced by 1 percentage point to 10 per cent per annum in August, 1987. Secondly, the statutory reserve ratios were reduced by a considerable margin in the same month, which resulted in the average reserve ratio on deposit liabilities declining from 12.3 per cent to 10.0 per cent.

With the implementation of the above measures, which in turn would have lowered the cost of funds to commercial banks, it was anticipated that the commercial banks would lower their lending rates significantly. However, in practice this was not so and the downward movement in the lending rates of commercial banks was very marginal. For instance, the weighted average lending rate of commercial banks which declined from 20.1 per cent at the end of 1985 to 19.0 per cent at the end of 1986, decreased only to 18.4 per cent by the end of September, 1987. Meanwhile, the lending rates of long-term credit institutions remained, by and large, unchanged during 1987.

Reference was made in last year's Annual Report to the problem of downward rigidity in the movement of interest rates of commercial banks which was a matter for concern. This failure of the interest rates to move downward sufficiently in keeping with the policy changes and market developments seems to reflect the oligopolic nature of Sri Lanka's commercial banking structure dominated by the state sector banks, which are saddled with high administrative costs, partly on account of an extensive branch net-work and high security related expenses. These banks have been engaged in some rationalisation of their operations, and if market forces are to play a greater role in the determination of interest rates, these measures will have to be intensified.

The year 1987 witnessed some measure of flexibility in monetary policy, as evident in the reduction of the statutory reserve requirements and a further augmentation of the refinance facilities from the Central Bank. In the context of relatively stable conditions with respect to price movements during the first half of the year, it was considered desirable to ease monetary policy modestly so as to provide a stimulus to economic activity.

The process of easing reserve pressure of commercial banks began in early 1986 with the withdrawal of the requirement to maintain special reserves under "the Tranche System" introduced in late 1984.* The next stage was the withdrawal in June, 1987 of the requirement to maintain reserves against unutilised balances of overdrafts, which was imposed in December, 1983. The last was the major revision in August, 1987 when the reserve ratios on various classes of deposits, which varied between 10 per cent and 18 per cent, were unified at 10 per cent and made applicable to all types of commercial banks' deposit liabilities. Consequent on this revision, the average reserve ratio on deposit

* The details of this Reserve Tranche System are given in page (V), Part II of the Annual Report, 1984.

liabilities declined from 12.3 per cent to 10 per cent, thereby reducing the costs of maintaining reserves.

With a view to further promoting short-term and medium-term lending to priority sectors of the economy, the Central Bank continued to provide refinance facilities to commercial banks and certain other financial institutions. The total outstanding refinance provided by the Bank under various schemes expanded by Rs. 344 million in 1987, to reach Rs. 3,496 million by the end of the year. To promote medium and long-term investment, a sum of Rs. 250 million was transferred to the Medium and Long-term Credit Fund (MLCF) from the general resources of the Bank during the year, thus enhancing the refinancing capacity of the Fund to Rs. 1,275 million.

As mentioned earlier, market forces came to play a greater role in the determination of the yield on primary Treasury bills since January, 1987. At the same time, commercial banks and other participants were induced to engage in more primary market activities by lowering the yield on secondary Treasury bills sold by the Central Bank. Furthermore, the weekly issues of Treasury bills helped to guarantee a regular supply of short-term paper for the investment of banks' liquid funds. Meanwhile, the reduction in the coupon rate on Central Bank securities and the extension of the maturity period from six months to one year made primary Treasury bills even more attractive. Consequently, Treasury bill holdings of the non-Central Bank sources increased from Rs. 4,059 million at the end of 1986 to Rs. 7,562 million by the end of 1987 accounting for 25 per cent of the total Treasury bills outstanding.

The Central Bank continued to influence the direction of credit in terms of the sectoral allocation of credit under the National Credit Plan. This Plan covered lending to the private sector by commercial banks, the NSB and the long-term credit institutions. In terms of the Credit Plan for 1987, commercial bank credit to the private sector (i.e. public corporations, co-operative institutions and the other private sector constituents) was expected to grow by 13 per cent, whereas private sector credit growth exceeded the target by Rs. 2,236 million or 41 per cent. High levels of credit utilised for agricultural purposes, particularly under the Medium Term Investment Programme (MTIP) for the development of state owned plantations, were very largely responsible for this. The growth of institutions and the expansion of priority needs sometimes make it difficult to forecast accurately the credit requirements on a sectoral basis.

The activities in the capital market continued on a modest scale, despite excess liquidity in the economy. The number of new share issues during the year were only five, the same as in the previous year. However, the value of shares on offer was Rs. 206 million, as compared with Rs. 130 million worth of shares on offer in the previous year. Two issues by the Sampath Bank Ltd. of Rs. 174 million without any special tax privileges, dominated the primary share market in 1987. As a measure to further develop the market, the Government enacted the Securities Council Act in 1987, which laid down the legal framework for the operation of an orderly share market, which is to be supervised by the new Securities Council.

As mentioned before, several factors, some of them clearly beyond its control affected Sri Lanka's economic performance, in 1987. In the agricultural sector, both

adverse weather conditions and continued civil disturbances contributed to dampen output. Tourism and fishing were affected by the civil disturbances. Long spells of drought in the catchment areas constrained hydro-power generation, and power cuts affected industrial production. Under the impact of these developments, the real GDP growth rate fell to 1.5 per cent, after a decade of impressive growth following the economic reforms of 1977. In fact, the growth in real GDP was barely sufficient to prevent per capita real GDP from falling, when allowance is made for the population growth. The economic growth in 1987 was the lowest since civil disturbances affected growth in 1971. It underscores the need for stable and peaceful conditions for sustained economic development.

There was some improvement in the balance of payments, with both trade and current accounts showing lower deficits, but the overall deficit remained large enough to cause concern regarding external stability. A major problem in the external sector in 1987 was that the weather affected agricultural output did not permit the full benefits of the up-turn in prices to be realised. Despite heavy investments in irrigation and hydro power, Sri Lanka continues to be highly vulnerable to vagaries of the weather. Along with rebounding of oil prices and the rise in debt service payments, the external sector continued to be most vulnerable. These developments reflected the harsh realities of a narrowly based, primary trade-dependent economy striving to maintain a reasonable rate of growth in a hostile environment. Thus, the Sri Lanka economy faces formidable challenge in 1988 and beyond. Given the paucity of natural resources and the limitations of the agricultural sector, Sri Lanka must necessarily go for a more diversified economic structure. But in doing so, she must make the very difficult transition from an economy dependent on a narrow export base and a large public sector with low productivity to one in which export oriented activities and the investment in productive ventures are the broad parameter of the development strategy aimed at a healthier and more balanced economy.

In the case of fiscal operations, although there was seemingly some improvement with a lower overall budget deficit, the continuation of expansionary financing in 1987, due to reduced capital flows inflicted deep rooted structural problems. Owing to production set-backs, supply shortages emerged in some food items, which together with an acceleration in the growth of money supply, led to a sharp increase in prices during the closing months of 1987. The resurgence of inflationary pressures should be dampened with utmost determination. Failure to achieve this would result in eroding the confidence in the economy. It needs to be recognised that for controlling inflation, the freedom of action in the field of monetary policy is somewhat limited, if the incentives for investment and production are not to be thwarted. In fact, the approach to monetary policy in the period ahead would require a delicate balancing of conflicting considerations. While monetary policy can provide adequate support for maintaining price stability, excessive monetary restraint involving adverse implications on investment and growth should be avoided.

The 1986 Annual Report drew attention to the need for fiscal restraint as a pre-requisite for the maintenance of macro economic stability—a condition vital for sustained economic expansion. The 1987 fiscal developments do not warrant any complacency on this score, but rather underscore the need for a further resolve at fiscal discipline, as the economic outlook continues to be clouded by a number of imbalances. In recent

years, despite successful efforts at maintaining government revenue as a proportion of GDP at around 20 per cent, the overall deficit remained around 11 per cent of GDP, largely owing to growing current expenditure. In this background, a broad outline of budgetary and balance of payments strategy for correcting structural weaknesses in the economy was spelt out in the Medium-Term Policy Framework, introduced in the budget speech for 1987. The policy framework for the 3 year period 1987-1989 was fundamentally aimed at ensuring macro economic stability and thereby improve prospects for future growth and self-reliance. Specific targets were set for the budget deficit and the current account deficit of the balance of payments. In terms of these targets, the budget deficit (before grants) was expected to be reduced from 11 per cent of GDP in 1987 to 9 per cent in 1989, while the current account deficit in the balance of payments was to decline from 7 per cent of GDP in 1987 to 5 per cent in 1989, a deficit that could be managed with highly concessional foreign resources.

However, in view of the unprecedented drought conditions, escalation of defence expenditure and the increase in expenditure anticipated from the reconstruction programme, both fiscal and balance of payments parameters had to be revised. Accordingly, in the Medium-Term Policy Framework for 1987-1990 announced in the 1988 budget speech, government revenue estimated at 21 per cent of GDP in 1987 was to remain around 20.5 per cent of GDP in the period 1988-1990, while expenditure is targetted to reduce progressively from 33 per cent of GDP in 1987 to 29.5 per cent in 1990. Within these limits, current expenditure/GDP ratio at 20 per cent in 1987 is expected to decline to 18 per cent during 1988-1990. The gradual reduction in the budget deficit is expected to be achieved through a progressive reduction in capital expenditure from 13 per cent of GDP in 1988 to 11.5 per cent of GDP by 1990. Based on this fiscal adjustment, current account deficit of the balance of payments, as a proportion of GDP is expected to decline from 9 per cent in 1987 to 5 per cent in 1990. The adjustment in the balance of payments assumes a fairly strong growth in exports and import substitution sectors following the adoption of a new industrial policy, export promotion and a programme of privatisation. In any case, conditions must be created to encourage the private sector to take up the slack created by the reduction in government capital expenditure.

The major assumption underlying the targets in the policy framework is that the great bulk of the macro adjustment must come from a scaling down of the budget deficit over the next several years, thus addressing the problem at its major source. It is crucial that the package of deficit reduction measures be fully implemented. Sri Lanka must come to grips with her underlying economic problems and correct the structural imbalance in the economy. In fact, the structural imbalances emerged largely due to an attempt to force the pace of development through a heavy expenditure programme significantly in excess of available resources. Basically, the balance of payments deficits and price pressure are the inevitable consequences of excessive growth of domestic expenditure, faster than what the economy can sustain on a non-inflationary basis. While recognising the demands of competing claims, fiscal policy cannot lose sight of the overriding need for maintaining macroeconomic balance. Sri Lanka must have the vision, the will and the discipline to recognise the constraints the country faces, and to conduct its affairs in a manner that permits the necessary adjustment to occur in an orderly manner, in the context of economic growth. Such action should contribute immensely to bolstering confidence in Sri Lanka's endeavours at economic advancement with international support.