ECONOMIC PERFORMANCE, PROBLEMS AND POLICIES IN 1989

In 1989, the Sri Lanka economy achieved a relatively modest rate of economic growth. The Gross Domestic Product (GDP) in real terms is estimated to have risen by 2.3 per cent compared with a growth of 2.7 per cent in 1988. Following the same trend, the Gross National Product (GNP), which is derived by allowing for the flow of net factor income abroad, showed a growth of 2.2 per cent compared with the real GNP growth rate of 2.6 per cent recorded in the previous year.

Admittedly the growth performance in 1989 is not very encouraging. However, given the strains under which the economy had to function in 1989, viz, sporadic civil disturbances and orchestrated work stoppages which not only affected economic activity but also undermined business confidence, and the adverse weather which seriously affected agricultural production, the growth performance can be considered very satisfactory. It reflects the capacity of the economy to withstand extreme pressures and yet generate positive results provided right policies and correct incentives are in place.

TABLE 1.1

National Income Statistics 1987 - 1989

Item	Amount (Rs. Million)			Growth Rate	
	1987	1988*	1989*	1988*	1989*
1. G.D.P.at Current Factor Cost Prices	177,731	203,516	228,373	14.5	12.2
2. G.D.P.at Constant (1982) Factor Cost Prices	115,922	119,050	121,729	2.7	2.3
3. G.N.P.at Current Factor Cost Prices	173,395	198,250	222,467	14.3	12.2
4. G.N.P.at Constant (1982) Factor Cost Prices	113,307	116,214	118,791	2.6	2.2
5. Mid Year Population ('000)	16,361	16,586	16,806	1.4	1.3
6. G.N.P.per Capita					
(i) At Current Prices (Rs.)	10,598	11,953	13,237	12.8	10.7
(ii At Constant Prices (Rs.)	6,925	7,007	7,068	1.2	0.9

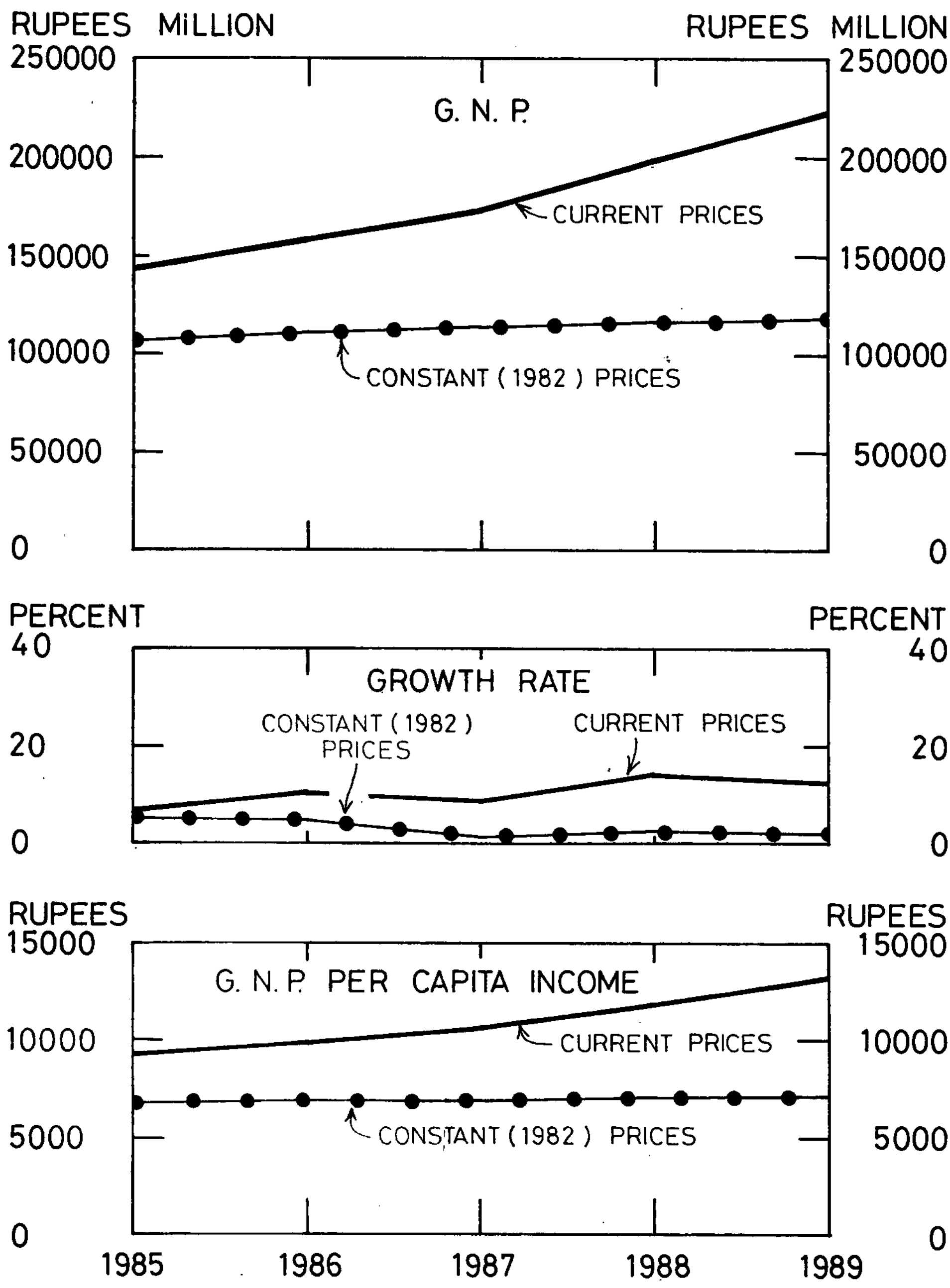
* Provisional

Source: Central Bank of Sri Lanka.

The GNP at current factor cost prices is estimated at Rs.222 billion in 1989, an increase of 12.2 per cent over 1988. Meanwhile, the implicit GNP deflator, an indicator of overall price changes in the economy, increased by 9.8 per cent, a rate slightly lower than 11.5 per cent recorded in 1988. Accordingly, the GNP at constant (1982) prices was estimated at Rs.122 billion reflecting a growth rate of 2.2 per cent. The slightly lower rate of GNP growth, compared to the GDP growth was due to the net outflow of factor income abroad, mainly interest payments.

According to provisional estimates of the Registrar General, Sri Lanka's population increased by 1.3 per cent to 16.8 million in 1989. Accordingly, the per capita GNP at current prices in 1989 is estimated at Rs. 13,237 (US $ 367). Although the per capita income at current prices grew by 10.7 per cent in 1989, in real terms the increase was only 0.9 per cent.

GROSS NATIONAL PRODUCT



Central Bank of Sri Lanka.

Domestic savings are estimated to have increased from Rs. 26.7 billion in 1988 to Rs. 30.6 billion in 1989 and as a ratio of GDP at market prices, domestic savings increased from 12.0 per cent to 12.1 per cent. Meanwhile, the national savings ratio, - the ratio of national savings to GDP at market prices - declined from 14.2 per cent to 14.0 per cent between the two years. This marginal drop in the savings rate is not surprising considering the low growth rate and the general destabilisation of activity during the year.

TABLE 1.2

Composition and Growth of G.N.P. 1987 - 1989 At Constant (1982) Factor Cost Prices.

Sector	Amount (Rs. Million)			Growth Rate		
	1987	1988*	1989*	1987	1988*	1989*
1. Agriculture Forestry and Fishing	27,409	27,984	27,666	-5.8	2.1	-1.1
of which						
1.1 Tea	2,750	2,926	2,668	1.0	6.4	-8.8
1.2 Rubber	765	770	697	-10.6	0.7	-9.5
1.3 Coconut	2,967	2,501	3,210	-24.6	-15.7	28.3
1.4 Paddy	5,423	6,312	5,258	-18.0	16.4	-16.7
1.5 Other(OtherAgriculture, Forestry and Fishing)	15,504	15,475	15,833	3.5	-0.2	2.3
2. Mining and Quarrying	3,112	3,392	3,576	19.0	9.0	5.4
3. Manufacturing	18,748	19,622	20,488	6.8	4.7	4.4
3.1 Tree Crop Processing	3,340	3,273	3,257	3.6	-2.0	-0.5
3.2 Other	15,408	16,349	17,231	7.5	6.1	5.4
4. Construction	8,338	8,463	8,514	1.8	1.5	0.6
5. Services	58,315	59,589	61,485	2.7	2.2	3.2
6. G.D.P.	115,922	119,050	121,729	1.5	2.7	2.3
7. Net Factor Income from Abroad	-2,615	-2,836	-2,938	-	-	-
8. G.N.P.	113,307	116,214	118,791	1.6	2.6	2.2

* Provisional

Source: Central Bank of Sri Lanka.

In 1989, the rate of capital formation suffered a set-back, which is a matter for serious concern from the view point of future growth prospects. The Gross Domestic Capital Formation (GDCF), inclusive of changes in stocks, recorded an increase of 8 per cent in 1989, compared with a rise of 10 per cent in 1988. Consequently, the ratio of GDCF to GDP at market prices declined from 22.8 per cent in 1988 to 21.7 per cent in 1989. Contrary to the general pattern in recent years, in 1989 the larger contribution to capital formation came from the private sector. The combined capital formation of the private sector and public corporations increased by 16 per cent as compared with a rise of 7.8 per cent in the previous year. Meanwhile, the GDCF of the Government decreased by 14.5 per cent over the previous year due to a curtailment of government capital expenditure.

The lack-lustre performance of the agriculture sector was the major contributory factor for the sluggish growth performance in 1989. The value added in the agriculture sector as a whole (including forestry and fishing) recorded a decline of 1.1 per cent, in contrast to a growth of 2.1 per cent in the previous year. Within the agriculture sector, the growth trends were exactly reversed between the two years. Whereas in 1988 all sub-sectors, except coconut, showed positive growth, in 1989 only the coconut sector recorded positive growth. The value added in tea and rubber declined by 8.8 per cent and 9.5 per cent, respectively in 1989. In the paddy sector, the overall output declined by 16.7 per cent as compared with an increase of 16.4 per cent in 1988. However, the coconut sector showed considerable resilience in 1989 and output increased by 28 per cent due to the lagged effect of favourable weather conditions that prevailed in 1988. Meanwhile, the value added in the 'other agriculture' sub-sector which includes forestry and fishing, grew by 2.3 per cent in 1989, as against a 0.2 per cent decline in the previous year. Overall, as the agriculture sector contributes about 24 per cent to the GDP, the decline in the value added of this sector had a major impact on the overall economic performance in 1989.

Among the major contributors to economic growth in 1989 were the Manufacturing and Services Sectors. The increase in value added in the Manufacturing Sector, which included agricultural processing, factory industries and small industries, was estimated at 4.4 per cent. The output of the factory industry which contributed around two-thirds of the total production in the Manufacturing Sector, expanded by 6 per cent. The entirety of this growth originated in the private sector, demonstrating its capacity to operate under extreme pressures. Meanwhile, the value added in the Services Sector increased by 3.2 per cent in 1989. Within this sector, banking and insurance, trade, and public administration and defence recorded relatively high growth. However, the value added in electricity, gas, water and sanitary services increased by only 1.8 per cent, as compared with 3.5 per cent growth in the previous year. The Transport, Storage and Communications sub-sector performed well in 1989 largely due to the improved performance of the Air Lanka Ltd.

Among the other sectors contributing to growth in 1989 was the Mining and Ouarrying Sector the output of which is estimated to have risen by 5 per cent. The major share of this growth came from Mineral Sands which recorded an output growth of 30 per cent during the year. On the other hand, gem mining which had been the leading growth sub-sector within this sector in the recent past, performed below expectations in 1989. Meanwhile, the Construction Sector which recorded a growth rate of 1.5 per cent in 1988, grew only marginally by 0.6 per cent in 1989 under the impact of a curtailed public investment programme.

In 1989, the agricultural sector suffered a severe setback, with the output of most commodities recording decreases. Tea production declined by 9 per cent and rubber by 10 per cent, while the output of paddy dropped significantly by 17 per cent. Among major crops, only coconut showed some improvement in production during the year. The performance of most minor export crops as well as minor food crops was also disappointing.

Tea production which reached a record 227 million kgs. in 1988 over two decades, declined sharply by 9 per cent to 207 million kgs. in 1989. The drop in production was reflected in all three elevational categories of teas, but it was more pronounced in the low grown areas where production fell by about 14 per cent to 83 million kgs. in 1989. The output of high grown tea fell by 4 per cent to 74 million kgs., while that of medium grown tea decreased by 8 per cent to 50 million kgs. The drought conditions in the early part of the year, heavy monsoonal rains experienced during the second quarter and the disruptions caused by the continuing civil unrest were the major factors contributing to the low output. The civil disturbances which affected every aspect of the tea industry by way of work stoppages, wanton distruction of tea factories, power supply and the transport facilities, and the low morale of the tea planters in general due to the atmosphere of terror and tension, were the most pervasive of these which hamstrung the tea industry in 1989.

As a result of low output, the quantity of tea sold at the Colombo Auctions fell by 7.4 per cent in 1989 to 193.6 million kgs., as compared with 209.1 million kgs. sold in1988. Tea prices at the Colombo Auctions strengthened considerably during 1989. The average gross price of tea at the Colombo Auctions increased by 28 per cent to Rs. 54. 61 per kg. as compared with the previous year. During the first two months of 1989, the average price at the Colombo Auctions at Rs. 42.71 was below that of the corresponding months of 1988. But since March 1989, the prices were on an upward trend with minor fluctuations in the peak cropping months of June and July. However, since September, there was a significant upsurge in prices and by end October the Colombo Auction gross price reached Rs. 72.12 per kg.

Reduced world supply and increased diversion of tea to the domestic market by India, were among the major factors contributing to the price upsurge. At the same time, increased purchases by the USSR in response to its own crop shortfall following the Chernobyl disaster contributed to strengthen the demand for tea at the Colombo Auctions. In addition, the exchange rate depreciation contributed to bolster prices in rupee terms at the Colombo Auctions. As a result of better prices, the producer margin of the JEDBs improved from a negative margin of Rs. 6. 90 per kg. in 1988 to a positive margin of Rs. 0.57 per kg. in 1989, while that of the SLSPCs also improved from a negative margin of Rs. 2.17 per kg. in 1988 to a positive margin of Rs. 3.15 per kg. in 1989.

Rubber production is estimated to have declined by 10 per cent to 110.7 million kgs. in 1989. Sporadic civil disturbances causing damage to a number of factories and interruptions to normal tapping operations were the major factors contributing to depress rubber production. The drought conditions that prevailed in the first quarter of 1989 as well as the heavy monsoonal rains and floods which occurred in most rubber growing areas during the second quarter were among the other factors responsible for poor production performance. In terms of output mix, the drop in production was more concentrated in crepe rubber the volume of which declined by 16 per cent in 1989 to 37.5 million kgs., while the output of sheet rubber decreased by 14 per cent to 54.3 million kgs. In contrast, the production of technically specified rubber (TSR) increased by 5 per cent to 18.9 million kgs. in 1989.

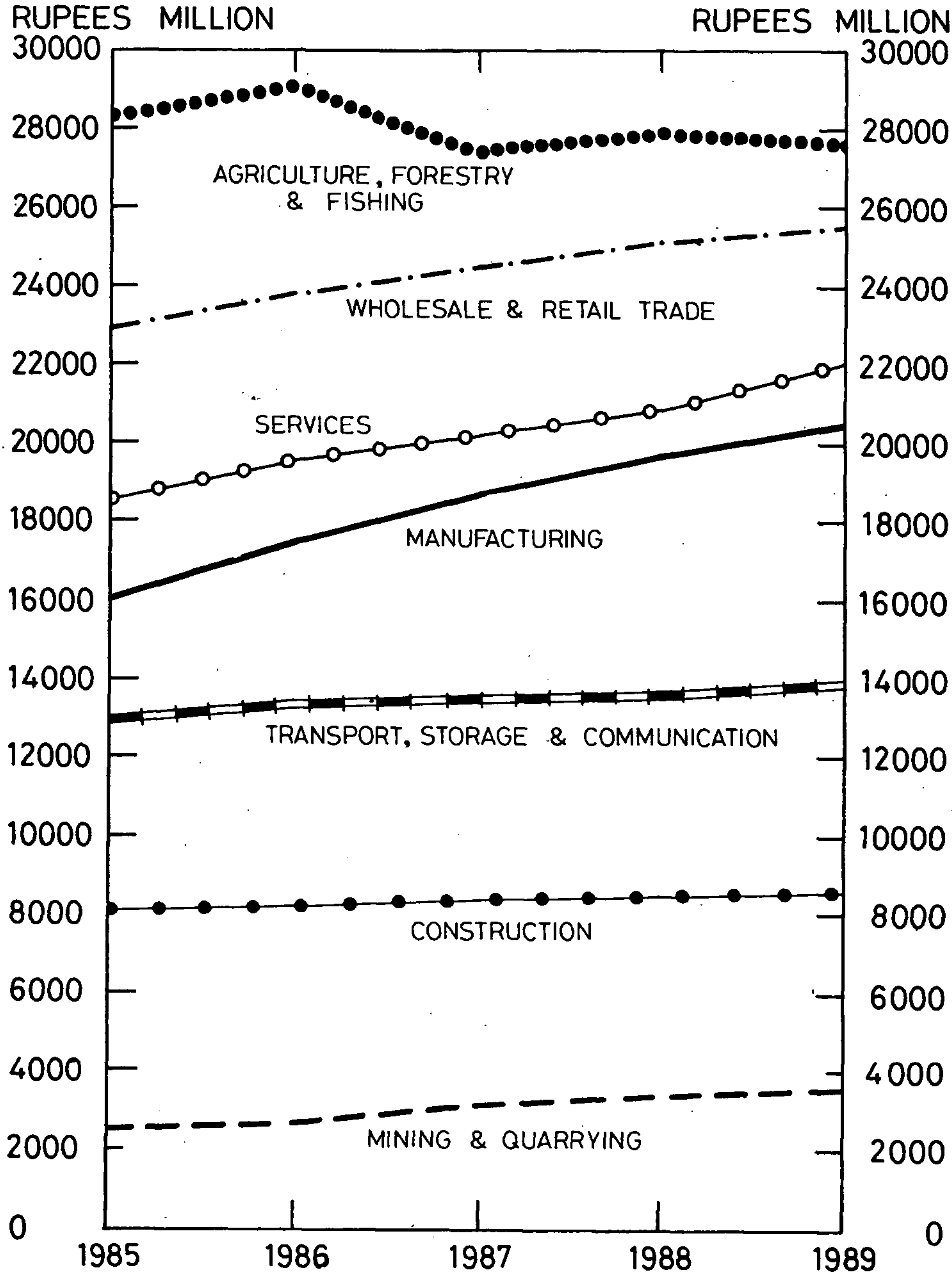
The decline in rubber production in 1989 was more pronounced in the public sector plantations. Rubber production (including rubber manufactured with bought latex) in the two public sector corporations - the JEDBs and SLSPCs - which accounted for about 31 per cent of total rubber production, was14 per cent lower in 1989 than in the previous year. Meanwhile, the rubber production of the private sector in 1989 was estimated at 76 million kgs., 7 per cent lower than the production reported in 1988.

The cost of production (COP) of rubber recorded significant increases both in the public sector and the private sector plantations, which was the outcome of higher wage costs and lower yields. The COP of the JEDBs increased by 18 per cent to Rs.29.25 per kg. in 1989, while that of the SLSPCs rose by 16 per cent to Rs. 26.71 per kg. The COP of the private sector is also estimated to have increased by 12 per cent to Rs. 15.01 per kg. in 1989.

Apart from the problem of reduced output, the rubber sector also had to cope with the problem of lower prices in 1989. The average export (f.o.b.) price of all varieties of rubber dropped by 3 per cent to Rs. 36.17 per kg. in 1989. The downward pressure on prices was mainly due to higher world supplies following increased production in major rubber producing countries such as Malaysia, Indonesia and Thailand. The average price of RSS1 at the Colombo Auctions declined by 7 per cent to Rs. 22.63 per kg. while that of RSS2 droped by 9 per cent to Rs. 21.77 per kg. over the previous year. The price of latex crepe I also decreased by 10 per cent to Rs. 29.42 per kg. in 1989. Consequently, the producer margin of the JEDBs declined from a positive margin of Rs. 3.0 per kg. in 1988 to a negative margin

GROSS DOMESTIC PRODUCT BY INDUSTRIAL ORIGIN

AT CONSTANT (1982) FACTOR COST PRICES



Central Bank of Sri Lanka.

of Rs. 1.25 per kg. in 1989. The producer margin of the SLSPCs also declined from Rs. 3.45 per kg. to a negative margin of Rs.1.14 per kg. between the two years.

While most major agricultural crops recorded decreases in output, coconut production alone registered a significant increase of 28 per cent to 2,486 million nuts in 1989. This was very largely due to the lag effect of improved rainfall experienced in the previous year. However, production in 1989 was substantially lower than the peak production of 3,039 million nuts recorded in 1986.

Following the increased supply of nuts, the production of three major coconut kernel products - desiccated coconut, coconut oil and copra - recorded substantial increases in 1989. The production of desiccated coconut and coconut oil more than doubled, while the export volume of copra recorded a significant increase of 41 per cent. The export volume of fresh nuts also increased by 1 million nuts. In general, the unsettled conditions in the country which adversely affected most other crop sectors appear to have had only a marginal adverse impact on coconut production.

Following production recovery and the consequent increased supplies, the nut prices in the domestic market declined in 1989. The average export (f.o.b.) price also dropped from Rs. 4 per nut in 1988, to Rs. 3.35 per nut in 1989. The prices of all three major coconut kernel products recorded decreases in the international market in response to the improved supply position in the major coconut producing countries, slack demand and increased availability of substitutes.

Paddy production which recorded an admirable 16 per cent growth in 1988 suffered a severe setback in 1989. The output of paddy in 1989 provisionally estimated at 2.06 million metric tons - the lowest level of production since 1979 - showed a 17 per cent decrease over the previous year. Paddy production in 1989 measured upto only 70 per cent of the targetted level of production. The fall in production was reflected in both Maha 1988/89 and Yala 1989 seasons, and was largely attributed to substantially reduced area sown and harvested, as well as the marginally lower yields mainly due to drought conditions which prevailed in the major paddy producing areas.

The availability of domestically produced rice for consumption which is equal to the rice equivalent of the total paddy production after adjusting for wastage and seed paddy requirements, was 1.23 million metric tons in1989. This represented only about 73 per cent of the total domestic rice requirements, as against 88 per cent provided in the previous year. In the context of reduced availability from domestic sources, the country's rice requirements had to be met through increased imports during the year. The volume of rice imports in 1989 was 316,000 metric tons, as compared with 210,000 metric tons imported in the previous year.

Another very significant development in the paddy sector in 1989 was a drastic contraction in the operations of the Paddy Marketing Board (PMB). Paddy purchases by the PMB under the Guaranteed Price Scheme (GPS) in 1989 dropped to an insignificant 5,036 metric tons from 105,000 metric tons in 1988. This was the lowest level of purchases ever recorded under the GPS and could be primarily attributed to lower paddy production, higher open market prices and the unsettled conditions which adversely affected the purchasing activities of the PMB. The guaranteed price of paddy remained unchanged at Rs. 80 per bushel during 1989.

Sugar production which increased significantly by 83 per cent to 53,521 metric tons in 1988, recorded only a marginal improvement of about 1 per cent to 53,983 metric tons in 1989. The factories at Hingurana and Kantale accounted for the entire increase in production. Sugar production at the Hingurana factory increased for the third consecutive year by 29 per cent to 14,250 metric tons in 1989, while that of the Kantale factory rose by 62 per cent to 2,305 metric tons. Meanwhile, sugar production at the Sevanagala factory dropped by 18 per cent to 9,078 metric tons, while that of the Pelwatte Sugar Company declined by 5 per cent to 28,350 metric tons in 1989. The decrease in production in both factories was due to reduced areas harvested, as well as a drop in the average yield mainly due to civil disturbances which affected normal plantation activities and caused work stoppages.

On the basis of export data, the production of all important minor export crops, except cinnamon and cashew, had suffered a severe setback in 1989. The export volume of pepper, cloves and coffee reported marked decreases of 41 per cent, 86 per cent and 57 per cent, respectively. Among other crops which recorded decreased export volumes were cocoa (10 per cent), nutmeg and mace (20 per cent) and cardamom (9 per cent) - indicating poor production performance. However, the export volume of cinnamon increased by 10 per cent and that of cashew nuts by 19 per cent when compared with the previous year.

The fish production in 1989 is provisionally estimated at 205,286 metric tons. This was a 4 per cent increase over the previous year. The rise in fish production in 1989 was largely reflected in the off-shore and deep-sea sub sector which recorded an 84 per cent increase in production mainly in response to expanded off-shore fishing activities with the rapid conversion of day-boats into multi-day boats. Meanwhile, fish production in the coastal fisheries sub sector and the inland sub sector recorded only marginal increases in 1989. According to estimates of the Department of Census & Statistics, milk production (including- buffalo milk) in 1989 was 238 million litres - an increase of 6 per cent over the previous year, while the total egg production was estimated at 834 million showing an increase of 7 per cent over the preceding year.

In contrast to the agricultural sector, the industrial sector was able to maintain its growth momentum in 1989, despite interruptions to production and distribution in the midst of continuing civil disturbances. Accordingly, the value of industrial output which grew by 6 per cent in real terms in 1988, increased by a further 6 per cent in 1989. However, the growth originated entirely in the private sector industry, demonstrating its resilience and capacity to withstand pressures of any nature. The output of private sector industry rose by 15 per cent in 1989. In contrast, the public sector tended to succumb easily to the pressures arising from civil disturbances and its output declined sharply by 21 per cent during the year. This was the third consecutive year when the value of output in public sector industries decreased.

Industrial sub sectors that recorded production increases in 1989 were fabricated metal products (17 per cent), textile, wearing apparel and leather products (16 per cent), food, beverages and tobacco (12 per cent). On the other hand, industrial sub sectors which recorded decreases in output were paper and paper products (20 per cent), chemicals, petroleum and plastic products (18 per cent), basic metal products (11 per cent) and non-metallic mineral products (5 per cent).

The improved performance in the textile wearing apparel and leather products category was mainly due to a substantial increase in the output of ready made garments both within and outside the Investment Promotion Zones. In the food, beverages and tobacco category, private sector industries showed an impressive performance largely due to increases in the output of a number of products such as tobacco, milk products, flour, confectionery and meat products. Although in the chemicals, petroleum and plastic products category the private sector recorded increased output, the overall output in this sector declined due to a sharp decrease in the output of the Ceylon Petroleum Corporation following the closure of the Refinery for maintenance purposes. The decline in the output of the wood and wood products category was due to the reduced output levels of the Ceylon Plywoods and State Timber Corporations, which wholly offset increased output in the private sector.

The sharp decrease in the output of public sector industrial enterprises in 1989 was the outcome of production short-falls in a number of important public sector industrial enterprises such as the Ceylon Petroleum, National Textile, Sri Lanka Cement, Ceylon Steel, National Paper, Ceylon Oils & Fats and Ceylon Tyre, Ceylon Plywoods, State Timber, State Mining and Mineral Development, Ceylon Leather Products, State Hardware Corporations. The disruptions caused to electricity supply, absenteeism and interruptions to production and distribution were the major underlying factors for the poor performance of these public sector industries. The corporation that recorded production increases during the year were Ceylon Mineral Sands (47 per cent), National Salt (41 per cent), State Distilleries (12 per cent), Sri Lanka Sugar (7 per cent) and Ceylon Ceramics (4 per cent).

Budgetary transfers to public sector industrial enterprises in 1989 amounted to Rs.380 million as compared with Rs.523 million in 1988. Of the transfers effected in 1989, Rs.231 million (61 per cent) were current transfers and the balance Rs.149 million (39 per cent) capital transfers. For the fifth consecutive year, the Sri Lanka Sugar Corporation received the largest share (87 per cent) of budgetary transfers to public corporations, in 1989. Other industrial enterprises that received budgetary transfers in 1989 were State Hardware, National Textile and Ceylon Oils and Fats Corporations.

Despite uncertainities, investment activity in the industrial sector continued, though at a lesser pace than in the previous years. The Greater Colombo Economic Commission (GCEC) approved 24 projects in 1989, as compared with 31 projects approved in 1988. As at the end of 1989, the total number of projects approved by the GCEC stood at 308. Of these approvals, agreements in respect of 178 projects had been signed by end 1989, of which 118 were in commercial production. The investment potential of the projects approved in 1989 was estimated at Rs.1,981 million. Meanwhile, the Foreign Investment Advisory Committee (FIAC), which co-ordinates foreign investment outside the GCEC, approved 62 projects in 1989. Total envisaged investment of these projects amounted to Rs.1,370 million, of which Rs.605 million or 44 per cent comprised foreign investment.

The year 1989 taken as a whole, there was a slight moderation in the average rate of price increase as compared with the previous year. The Colombo Consumers' Price Index recorded an annual averge increase of 11.6 per cent in 1989 compared to 14.0 per cent in 1988. However, this moderation in the rate of price increase was heavily concentrated in the first few months of the year. During the second half of 1989, there was a sharp acceleration in prices. Consequently, the point to point increase in the price index at the end of the year (December 1989 over December 1988) was 15.1 per cent, about the same rate as in the previous year. At the primary level too, there was a similar behaviour in prices in 1989 with the annual average of the Wholesale Price Index (WPI) rising by 9 per cent compared to 17.8 per cent in 1988, whereas on a point to point basis, (December 1989 over December 1988) the index registered an increase of 18.4 per cent reflecting heavy price pressure during the closing months of 1989.

The temporary improvement in the security situation during the first quarter of 1989 contributed to the moderation in prices observed during that period. During the first two months of 1989, the CCPI actually declined. However, from the second quarter onwards the deterioration in the security situation caused disruptions to production, trade and transport, resulting in shortages and escalation of prices. Drought conditions which caused supply shortages of certain agricultural commodities, rise in the prices of major imported food items both due to higher international prices and the exchange rate depreciation, the revision of petroleum prices and the upward revision of administered prices such as those on flour and bread were among the other factors contributing to exert pressure on the general price level during the latter part of 1989. However, stabilisation policies implemented in 1989 were successful in bringing about a greater degree of macro stability which in turn helped in easing pressure on prices emanating from the demand side. If not for the success achieved in controlling aggregate demand in the economy, price developments in 1989 would have been considerably worse. This reflects continuing commitment on the part of the authorities to maintain price stability in the economy.

During 1989, the price pressure had been reflected on a fairly wide front. In the Colombo Consumers' Price Index, the sub index for food rose by 10.3 per cent on an average, and this contributed 62 per cent of the overall increase in the index. Clothing prices rose sharply by 16.7 per cent compared with an increase of only 4.7 per cent in 1988. Prices of fuel and light items advanced by 12.0 per cent in the year under review as compared with 13 per cent in the previous year. The sub index for the miscellaneous group rose by 15.8 per cent surpassing the 14.1 per cent increase recorded in 1988.

The Wholesale Price Index (WPI) measures the price movements at the primary market level. In 1989, the annual average of the Wholesale Price Index rose by 9.0 per cent as compared with an increase of 17.8 per cent in 1988. On a point to point basis (December 1989 over December 1988), the index registered an increase of 18.4 per cent, far exceeding the 9.3 per cent rise recorded in 1988. As in the case of the Colombo Consumers' Price Index, the rise in the Wholesale Price Index was also mostly concentrated in the second half of the year. The strengthening of the export price of tea was a major factor that pushed the index up during the latter part of 1989.

In 1989, there were no major changes in the wage structure of government employees. The cost of living allowance payable to employees in the government sector also continued to remain frozen at the July 1988 level. Accordingly, although the average nominal wage levels of government employees as measured by their wage rate index advanced by 8.2 per cent, their real wages fell by 2.8 per cent in 1989. In the organised private sector, nominal wages as measured by the minimum wage rate index for workers in trades covered by Wages Boards increased by 15.6 per cent and their real wages were estimated to have increased by 3.8 per cent.

According to provisional estimates, employment in both the public and private sectors increased moderately in 1989. Within the public sector, employment in government institutions increased while that in semi-government institutions decreased marginally. In 1989, employment in government institutions which include all employees in government ministries and departments was estimated to have increased by 9.9 per cent to 588,500 as at the end of the year. The total number of employees in semi-government institutions at 749,700 however recorded a marginal decrease from th previous year's level. No reliable information is available with regard to the changes in the employment situation in the private sector in 1989. However, there was a 12.5 per cent increase in employment in the enterprises operating under the Greater Colombo Economic Commission (GCEC) whose employment level reached 61,429 persons as at the end of 1989. Meanwhile, the potential labour absorption capacity of the projects approved by the Foreign Investment Advisory Committee (FIAC) in 1989 was 4,999. Of the total labour absorption in FIAC projects up to the end of 1989, 53,697 (64 per cent) were employed in the manufacturing industries.

It is observed that the growth in employment opportunities in the public sector had been somewhat limited in 1989. One major reason for this was the attempt at restructuring and rationalisation of the public service following the recommendations of the Administrative

Reforms Committee. This also would mean that the capacity of this sector to create additional employment opportunities in the immediate future will be that much limited. This being the case, considerable progress will have to be made in creating employment opportunities in both the private sector and the self-employed sector to cope with the problem of growing unemployment and to prevent it becoming a source of serious social unrest. It underscores the need for creating appropriate conditions in these sectors so as to absorb increasing numbers entering the labour force in the coming years.

The developments, in Sri Lanka's external trade sector were relatively less unfavourable in 1989 than in the previous year. The value of merchandise exports expanded by 11 per cent, to SDR 1,216 million (Rs.56,175 million), as compared with a marginal growth of less than 2 per cent in 1988. On the other hand, the expenditure on imports rose by only 5 per cent to SDR 1,737 million (Rs.80,225 million), which was the same rate of increase as in the previous year. Consequently, the trade deficit in 1989 dropped by 8 per cent to SDR 521 million (Rs.24,050 million) as compared with the deficit of SDR 564 million (Rs.24,102 million) in the previous year. Meanwhile, the export earnings as a ratio of import payments increased appreciably from 66 per cent in 1988 to 70 per cent in 1989. On the other hand, however, the price movements of Sri Lanka's exports and imports continued to remain unfavourable. The average export price index rose by 11 per cent, while the average import price index recorded an increase of 18 per cent. As a result, the terms of trade deteriorated by 6 per cent in 1989, on top of the terms of trade loss of 7 per cent suffered in the previous year.

The higher growth of exports in 1989 was mainly due to increased earnings from tea, coconut, textile and garments and other industrial exports. The increased earnings from these exports were more than sufficient to offset the reductions from other exports such as rubber, minor agricultural products and petroleum exports. On the import front, the rise in import payments in 1989 was wholly due to increased commitments on consumer goods and intermediate goods. The outlay on consumer goods imports increased by 11 per cent while that on intermediate goods rose by 4 per cent.

On the basis of Customs data, the value of tea exports increased by 3 per cent, from SDR 288 million (Rs.12,299 million) in 1988 to SDR 296 million (Rs.13,664 million) in 1989. This was entirely due to a price increase of 11 per cent, from SDR 1.31 per kg, to SDR 1.45 per kg. In contrast, the volume of exports fell by 7 per cent, from 220 million kgs, to 204 million kgs. Meanwhile, the earnings from exports of rubber fell sharply by 23 per cent, from SDR 87 million (Rs.3,706 million) in 1988 to SDR 67 million (Rs.3,112 million) in 1989. Decreases in both the volume and the price contributed to this decline in earnings. The export volume of rubber decreased by 13 per cent, from 99 million kgs, to 86 million kgs., while the f.o.b. price dropped by 10 per cent, from SDR 0.87 per kg. to SDR 0.78 per kg. between the two years. In contrast to rubber, the earnings from coconut exports rose significantly by 72 per cent, from SDR 36 million (Rs.1,538 million) in 1988 to SDR 62 million (Rs.2,865 million) in 1989. This was wholly due to a more than two-fold increase in the export volume, from 224 million nuts to 572 million nuts. In contrast, the average export price of coconut kernel products fell by 22 per cent, from SDR 0.09 per nut in 1988 to SDR 0.07 per nut in 1989. The export earnings from minor agricultural products dropped sharply by 13 per cent in 1989 to SDR 52 million (Rs.2,408 million) from SDR 60 million (Rs.2,561 million) in 1988, in sharp contrast to a 33 per cent increase recorded in the previous year. Meanwhile, the value of industrial exports expanded significantly by 16 per cent, from SDR 530 million (Rs.22,674 million) in 1988 to SDR 616 million (Rs.28,470 million) in 1989. The impressive growth in industrial exports was mainly the outcome of increased earnings from textile and garments, and other industrial exports such as diamonds, chemicals and rubber products. The total value of mineral exports, however, dropped by 5 per cent in 1989, from SDR 61 million (Rs.2,614 million) in 1988 to SDR 58 million (Rs.2,693 million) in 1989. The decrease was reflected in gems as well as other mineral exports.

With these developments, the country's export composition underwent further change in 1989. The most noteworthy change was the rise in the share of industrial exports from 48 per cent in 1988 to 51 per cent in 1989, thus pushing the share of industrial exports in total exports above the 50 per cent level. Meanwhile, the share of agricultural exports declined further from 43 per cent to 39 per cent between the two years. The share of mineral exports also fell from 5.6 per cent to 4.8 per cent. Textile and garments continued to be the single major category of exports - a position reached in 1986 - accounting for 31 per cent of the total exports in 1989. The comparable share in 1988 was 30 per cent.

According to adjusted Customs data, total outlay on imports amounted to SDR 1,737 million (Rs.80,225 milion) in 1989, as compared with SDR 1,661 million (Rs.71,030 million) in 1988 showing an increase of 5 per cent. The increase was wholly reflected in the imports of consumer and intermediate goods. In contrast, investment goods imports declined by 8 per cent in 1989. The expenditure on imports of consumer goods rose somewhat sharply by 11 per cent, from SDR 408 million (Rs.17,438 million) in 1988 to SDR 454 million (Rs.20,962 million) in 1989, largely owing to increased outlays on rice and sugar imports. The expenditure on rice imports rose sharply by 74 per cent to SDR 74 million, while that on sugar imports increased by 37 per cent to SDR 94 million. The increased outlay on rice imports was due to both the volume (50 per cent) and price (16 per cent) increases. The expenditure on sugar imports rose wholly due to a price increase.

The outlay on intermediate goods imports increased by 4 per cent, from SDR 943 million (Rs. 40,325 million) in 1988 to SDR 980 million (Rs. 45,255 million) in 1989, largely due to higher expenditure on imports of wheat grain and textiles and clothing. Meanwhile, the expenditure on imports of investment goods decreased by 8 per cent, from SDR 283 million (Rs. 12,081 million) in 1988 to SDR 260 million (Rs. 12,018 million) in 1989. The decline was reflected mainly in the imports of machinery and equipment, probably reflecting fewer new industrial ventures established during the year.

In 1989, Sri Lanka's balance of payments developments turned out to be significantly less unfavourable than what was originally anticipated. Whereas in terms of the mid year forecast the overall deficit was expected to be around SDR 170 million, the year ended with an overall deficit of only SDR 67 million. During the first half of 1989, there was intense pressure on the balance of payments with considerable loss of reserves. However, a sharp turn-around was observed during the second half, particularly since September, following the restoration of confidence in the economy in the wake of the implementation of economic stabilisation measures and the improvement in the security situation. The gross official reserves which had declined to SDR 125 million at the end of June, 1989 reached SDR 224 million by the end of the year. Similarly, total gross reserves rose from SDR 385 million at the end of June to SDR 447 at the end of December, 1989. This recovery in the balance of payments position was one of the most encouraging features of Sri Lanka's economic performance in 1989.

TABLE 1.3

Summary of Balance of Payments 1986 - 1989

Rs.Million (SDR million in brackets)

Item	1986	1987	1988(a)	1989(b)
Merchandise (Net)	-21,390 (-649)	-20,005 (-525)	-24,268 (-568)	-24,716 (-542)
Non-Factor Services (Net)	255 (8)	74 (2)	382 (8)	591 (11)
Factor Services (Net)	-3,871 (-117)	-4,699 (-123)	-5,266 (-122)	-5,906 (-128)
Private Transfers (Net)	7,983 (242)	9,226 (242)	10,187 (238)	10,844 (234)
Official Transfers (Net)	5,114 (153)	5,311 (139)	6,588 (154)	6,190 (135)
Current Account Balance	-11,909 (-363)	-10,093 (-265)	-12,377 (-290)	-12,997 (-290)
Overall Balance	-1,774 (-65)	-1,224 (-62)	-3,339 (-64)	-1,905 (-67)
Some Key Indicators				
Terms of Trade (1981 = 100)	111	114	106	99
Net Petroleum Imports	3,935 (120)	6,124 (161)	5,574 (130)	6,134 (133)
Current Account Deficit as a Percentage of G.D.P.	6.7	5.1	5.6	5.1
Gross International Reserves	17,152 (492)	18,479 (423)	19,025 (428)	23,390 (447)
International Reserves in Months of Imports	3.5	3.2	3.1	3.1

Source: Central Bank of Sri Lanka.

(a) Revised
(b) Provisional.

The merchandise account of the balance of payments registered a deficit of SDR 542 million (Rs. 24,716 million) in 1989 which was 5 per cent lower than the deficit of SDR 568 million (Rs. 24,268 million) recorded in 1988. In contrast, the deficit in the services account rose marginally from SDR 114 million (Rs. 4,884 million) to SDR 117 million (Rs. 5,315 million) between the two years. The current account deficit at SDR 290 million (Rs. 12,997 million) remained more or less at the same level as in 1988. However, the current account deficit as a ratio of GDP declined to 5.1 per cent from 5.6 per cent in 1988. The current account deficit excluding official transfers as a ratio of GDP decreased even more strikingly from 8.5 per cent to 7.6 per cent between the two years.

The performance in the service account of the balance of payments showed little change in 1989 except for the turn-around in the travel account. Foreign exchange earnings from travel and allied services increased from a deficit of SDR 2 million in 1988 to a surplus of SDR 3 million in 1989. This was mainly due to a significant increase in tourist arrivals during the closing months of 1989 following an improvement in the security situation. Meanwhile, the net outflow on account of investment income in 1989 at SDR 128 million was somewhat higher than in the previous year, the major reason being the reduced interest income from foreign portfolio investments by the Central Bank. As in previous years, the interest payments on foreign loans, at SDR 161 million, accounted for a major share of total service payments amounting to SDR 418 million.

A notable adverse development in the balance of payments in 1989 was the reduced receipts on account of transfers. Net receipts from transfers decreased to SDR 370 million in 1989, the lowest level since 1985. This was very largely due to a sharp reduction in official transfers which dropped by 12 per cent to SDR 136 million in 1989. In comparison, foreign exchange receipts from private transfers consisting mainly of remittances by Sri Lankans working abroad at SDR 263 million were only marginally lower than in 1988.

Meanwhile, the developments in the capital account of the balance of payments in 1989 were less favourable than in 1988. Although net monetary capital inflows in 1989 at SDR 252 million reflected an increase of 30 per cent over the previous year, the increase was almost entirely due to the enhanced utilisation of trade credits and a commercial loan from USA for the financing of wheat imports. On the other hand, direct investments declined by 34 per cent to SDR 21 million, while there was a net outflow of SDR 23 million on account of private long term loans. While a larger volume of resources came from private short-term sources, there was an 8 per cent reduction in net official capital inflows, from SDR 182 million in 1988 to SDR 167 million in 1989, which was almost entirely due to a 12 per cent reduction in disbursements under project loans. As the resources available from non-monetary capital flows were lower than the current account deficit, the balance had to be financed by monetary movements. The deficit that had to be so financed was SDR 67 million in 1989. Sri Lanka's gross external assets stood at SDR 447 million (Rs. 23,389 million) at the end of 1989 reflecting an improvement over the previous year's level of SDR 428 million (Rs. 19,025 million). However, the net external assets position deteriorated between the two years reflecting the overall deficit in the balance of payments referred to above.

Although the balance of payments developments in 1989 were less unfavourable than those anticipated in the early part of the year, the fact that the year ended with an overall deficit of SDR 67 million is a matter which should deserve serious attention. This was the fifth consecutive year in which the country's balance of payments was in overall deficit and it underscores the need for continued adjustment effort by way of a substantial improvement in export performance, efficient import substitution and adequate inflows of non-debt creating capital which alone will ensure balance of payments viability in the long-run.

The Sri Lanka Rupee depreciated against all major currencies in 1989 - the Rupee depreciated against the Japanese Yen by 6.6 per cent, Pound Sterling by 9.2 per cent and the US Dollar, the intervention currency, by 17.4 per cent. It also depreciated by 22 per cent each against the Deutsche Mark and the French Franc while depreciating against the Indian Rupee by 7.4 per cent during the year. Against the SDR, the Rupee depreciated by 16.3 per cent in 1989.

Sri Lanka's total outstanding external debt stood at SDR 3,960 million at the end of 1989 recording an increase of 7 per cent over the previous year. The medium and long-term debt continued to account for over 90 per cent of the total outstanding external debt. However, the short-term debt rose significantly in 1989 due to considerable increases in both short-term borrowings by the Central Bank and increased utilisation of trade credits. Meanwhile, there was a 10 per cent increase in the indebtedness to the IMF in 1989, mainly due to the drawing of SDR 67 million under the SAF. The debt service payments, consisting of amortization payments on medium and long-term loans and interest payments on all foreign loans, decreased by SDR 32 million to SDR 371 million in 1989. Total debt service payments as a ratio of earnings from exports of goods and services decreased from 28.7 per cent in 1988 to 24.4 per cent in 1989. This ratio, excluding IMF transactions, was 19.9 per cent as compared with 22.8 per cent in the previous year.

TABLE 1.4

Summary of Government Fiscal Operations

Rs. Million

Item	1984	1985	1986	1987	1988	1989 Appproved Estimates	1989 Provi-sional	1990 Budget
Total Revenue and Grants	37,354	39,556	40,991	46,822	48,337	61,720	60,410	68,062
Total Revenue	34,061	36,249	37,238	42,145	41,749	56,120	54,003	61,262
Tax Revenue	29,939	30,442	31,272	35,119	35,946	48,729	47,419	55,920
Non Tax Revenue	4,122	5,807	5,966	7,026	5,803	7,391	6,584	5,342
Grants	3,293	3,307	3,753	4,677	6,588	5,600	6,407	6,800
Expenditure and Lending Minus Repayments	47,837	55,234	59,193	63,894	76,532	90,322	79,093	89,861
Current	24,630	32,645	33,966	39,560	46,132	56,619	54,981	64,161
Capital	19,915	21,530	23,236	22,816	22,878	28,694	19,644	21,053
Lending Minus Repayments	3,292	1,059	1,991	1,518	7,522	5,009	4,468	4,647
Current Account Surplus/Deficit(-)	9,431	3,604	3,272	2,585	-4,383	-499	- 979	-2,899
Budget Deficit (before Grants)	-13,776	-18,985	-21,956	-21,749	-34,783	-34,202	- 25,091	-28,599
Budget Deficit (after Grants)	-10,483	-15,678	-18,204	-17,072	-28,195	-28,602	- 18,684	-21,799
Financing	10,483	15,678	18,204	17,072	28,195	28,602	18,684	21,799
Foreign Borrowings	6,492	7,109	9,061	5,716	7,128	12,004	5,926	10,558
Domestic Borrowings	3,991	8,569	9,143	11,356	21,065	16,598	12,576	11,241
Non Market Borrowings	951	-1,801	-669	1,415	1,413	-	227	-
Market Borrowings	3,040	10,370	9,812	9,941	19,652	16,598	12,529	11,241
Non Bank	5,135	5,659	6,765	6,400	9,227	13,203	13,648	10,199
Bank	-2,095	4,711	3,047	3,541	10,425	3,395	-1,119	1,042

(as a percentage of GDP)

Item	1984	1985	1986	1987	1988	1989 Appproved Estimates	1989 Provi-sional	1990 Budget
Total Revenue and Grants	24.3	24.4	22.8	23.8	21.7	23.3	24.1	24.0
Total Revenue	22.2	22.3	20.8	21.4	18.7	21.1	21.6	21.6
Tax Revenue	19.5	18.7	17.4	17.9	16.1	18.4	19.0	19.7
Non Tax Revenue	2.7	3.6	3.3	3.6	2.6	2.8	2.6	1.9
Grants	2.1	2.0	2.1	2.4	3.0	2.1	2.6	2.4
Expenditure and Lending Minus Repayments	31.1	34.0	33.0	32.5	34.3	34.0	31.6	31.7
Current	16.0	20.1	18.9	20.1	20.7	21.3	22.0	22.6
Capital	13.0	13.3	13.0	11.6	10.3	10.8	7.9	7.4
Lending Minus Repayments	2.1	0.7	1.1	0.8	3.4	1.9	1.8	1.6
Current Account Surplus/Deficit(-)	6.1	2.2	1.8	1.3	-2.0	-0.2	-0.4	-1.0
Budget Deficit (before grants)	-9.0	-11.7	-12.2	-11.1	-15.6	-12.9	-10.0	-10.1
Budget Deficit (after grants)	-6.8	-9.7	-10.1	-8.7	-12.6	-10.8	-7.5	-7.7
Financing	6.8	9.7	10.1	8.7	12.6	10.8	7.5	7.7
Foreign Borrowings	4.2	4.4	5.1	2.9	3.2	4.5	2.4	3.7
Domestic Borrowings	2.6	5.3	5.1	5.8	9.4	6.3	5.1	4.0
Non Market Borrowings	0.6	-1.1	-0.4	0.7	0.6	-	0.1	-
Market Borrowings	2.0	6.4	5.5	5.1	8.8	6.3	5.0	4.0
Non Bank	3.3	3.5	3.8	3.3	4.1	5.0	5.5	3.6
Bank	-1.4	2.9	1.7	1.8	4.7	1.3	-0.4	0.4

Source : Central Bank of Sri Lanka.

An outstanding feature of Sri Lanka's macro economic developments in 1989 had been a marked improvement in fiscal performance, which turned out to be even better than the original estimates as well as the targets set under the economic stabilisation programme. The overall budget deficit was contained at Rs. 25,091 million or 10.0 per cent of GDP as compared with a targetted deficit of 12.5 per cent of GDP and the previous year's deficit of 15.6 per cent. The improvement was a combined effect of both increased revenue and reduced expenditure. The government revenue/GDP ratio was more or less at the targetted level of 21.3 per cent. Meanwhile, there was a substantial reduction in government outlays which enabled total expenditure as a proportion of GDP to be reduced to 31.6 per cent, as against 33.8 per cent originally targetted. The larger share of the reduction in government expenditure was reflected in capital votes. Following these developments, the budget deficit as a ratio of GDP which was 15.6 per cent in 1988 declined to 10.0 per cent in 1989. Apart from the reduction in the budget deficit, there were also favourable trends in financing the deficit, in that resources available from non-expansionary sources were sufficient to finance the deficit in full, thereby totally eliminating the need for resorting to expansionary financing.

Government revenue in 1989 at Rs. 54,003 million showed an increase of 29 per cent. Tax revenue at Rs. 47,419 million reflected an increase of 32 per cent over the previous year and contributed approximately 90 per cent of total revenue in 1989, as compared to 86 per cent in the previous year. Revenue collections from major sources such as import duties, turnover taxes, excise duties were considerably higher than those from the same sources in 1988. Additional tax revenue amounting to Rs. 2,345 million was also generated from a tax imposed on Treasury bills held by the Central Bank. The growth in revenue from these sources resulted in the tax/GDP ratio rising from 16 per cent in 1988 to 18.9 per cent in 1989.

On the expenditure side, major current expenditure items such as salaries and wages, household transfers, pensions and transfers to public corporations showed considerable growth during the year. The expenditure on salaries and wages at Rs.12,981 million was an increase of 30 per cent over such expenditure in the previous year, and as a proportion of GDP rose to 5.2 per cent in 1989 from 4.5 per cent in 1988. Meanwhile, transfer payments in 1989 amounted to Rs.16,099 million showing an increase of 25 per cent over the previous year. Interest payments on the government debt at Rs.14,346 million reflected an increase of 14 per cent. However, interest payments on the government debt as a proportion of GDP at 5.6 per cent remained at the same level as in the previous year. Reflecting these increases, the total current expenditure of the government totalled Rs.54,981 million, an increase of 19 per cent over 1988 and the current expenditure/GDP ratio rose to 22.0 per cent in 1989 from 20.7 per cent in the previous year. However, on account of improved revenue performance, the deficit in the current account of the budget was reduced to Rs.979 million compared with the deficit of Rs.4,383 million in 1988.

In contrast to current expenditure, total capital expenditure at Rs.19,644 million recorded a 14 per cent drop in 1989. Accordingly, capital expenditure/GDP ratio fell from 10.3 per cent in 1988 to 7.9 per cent in 1989. The decline in capital expenditure was largely due to implementation problems in foreign funded projects, such as rehabilitation programmes and road development projects, on account of the unsettled conditions that prevailed during the year.

Despite the reduction in capital expenditure, total government expenditure and lending minus repayments at Rs.79,093 million recorded a marginal increase of 3 per cent over 1988. However, the total expenditure and lending minus repayments in relation to GDP declined from 34.3 per cent in 1988 to 31.6 per cent in 1989. The overall outcome of the revenue and expenditure flows was to generate a budget deficit (before grants) of Rs.25,091 million which was considerably lower than the deficit of Rs.34,202 million recorded in 1988 and the targetted deficit of Rs.31,251 million for 1989. Accordingly, the budget deficit/GDP ratio fell from 15.6 per cent in 1988 to 10.0 per cent in 1989. In financing the deficit, a total sum of Rs.5,926 million was mobilised from foreign sources in the form of concessionary loans, which was 17 per cent lower than the amount utilised in 1988. In relation to GDP, foreign borrowings for budgetary puposes were 2.4 per cent, as compared with 3.2 per cent borrowed during the previous year. Meanwhile, a total sum of Rs.12,758 million was obtained from domestic sources towards financing the deficit. The contribution from the non-bank sector was Rs.13,648 million, an increase of 47 per cent over the prevous year. Of this sum, Rs.4,875 million was raised through rupee loans and Rs.8,929 million by way of Treasury bills. As a proportion of GDP, the contribution from the non-bank sector rose from 4.1 per cent of GDP in 1988 to 5.5 per cent in 1989. While the non-bank sector became a major domestic source for financing the budget deficit, contribution from the banking sector was negative as there was a net repayment of Rs.1,119 million to the banking system in 1989. This was in sharp contrast to the position in the previous year when the government utilised Rs.10,425 million (4.7 per cent of GDP) from the banking system for budgetary purposes.

The outstanding government debt at the end of 1989 amounted to Rs.272,305 million, reflecting an increase of 21 per cent over the outstanding debt at the end of the previous year. The total domestic debt at Rs.117,561 million recorded an increase of 19 per cent, while the foreign debt amounting to Rs.154,744 million registered a growth of 23 per cent. The share of short-term debt in the total debt rose from 49 per cent in 1988 to 54 per cent in 1989, reflecting largely the increased reliance on Treasury bills rather than rupee securities for raising funds for financing the Budget deficit in 1989. The domestic debt accounted for 43 per cent of the total outstanding government debt at the end of 1989. Of the domestic debt, the outstanding liabilities on account of rupee securities, which formed almost the entire medium and long-term domestic debt, at Rs.54,217 million registered an increase of 9.4 per cent over the level in the previous year. A total sum of Rs.8,672 million was raised through rupee securities during the year. But the outstanding debt on account of rupee loans rose by only Rs.4,875 million as repayments of rupee loans during the year totalled Rs.3,797 million.

The total resources raised by the issue of Treasury bills, the principal instrument of short-term borrowings of the government, amounted to Rs.13,546 million, almost the same volume of resources raised in the previous year. However, subscriptions by the banking system to Treasury bills at Rs.3,585 million was substantially lower than the sum of Rs.11,249 million subscribed in the previous year. A significant development in 1989 was that the non-bank sources invested as much as Rs.9,960 million in Treasury bills, as compared with Rs.2,678 million in 1988. While the outstanding liability on account of Treasury bills rose from Rs.43,700 million at the end of 1988 to Rs.57,246 million at the end of 1989, the Central Bank's holdings of Treasury bills rose only marginally, from Rs.33,270 million to Rs.34,098 million. Accordingly, the share of Central Bank's holdings of outstanding Treasury bills fell from 76 per cent as at the end of 1988 to 60 per cent at the end of 1989.

The outstanding foreign debt of the Government as at the end of 1989 totalled Rs.154,744 million recording an increase of 23 per cent over the previous year. The share of foreign debt in the total public debt rose marginally from 56 per cent in 1988 to 57 per cent in 1989. Although the net foreign borrowings for budgetary purposes during 1989 were only Rs.5,926 million, the outstanding foreign debt as at the end of the year recorded a substantial increase of Rs.29,087 million due to an additional rupee liability of Rs.23,162 million on account of exchange rate variations during the year. The total foreign debt at the end of 1989 comprised Rs.110,294 million of project loans and Rs.44,450 million of non-project loans.

Debt service payments of the government, consisting of amortisation and interest payments amounted to Rs.24,206 million in 1989, an increase of 9 per cent over the previous year. However, the total debt services payments on the government debt as a ratio of GDP at 10 per cent remained at the same level as in the previous year.

A significant deceleration in the rate of growth of money supply was one of the most salient features of macro-economic developments in 1989. The annual rate of growth of narrow money supply (M_1) which was 29 per cent at the end of 1988 decreased to 9 per cent by the end of 1989. Following a similar trend, the annual rate of growth of broad money supply (M_2) declined from 16 per cent to 12 per cent over the same period. These developments were most reassuring when viewed in the context of the stabilisation programme that was in operation during the year, following the serious macro economic destabilisation that occurred in 1988. The growth rates in monetary aggregates were broadly in line with the targets set for the year under the programme, which in turn, helped in achieving other stabilisation objectives of the programme.

It is observed that the deceleration in the growth of money supply in 1989 was more pronounced in the narrow monetary aggregate. The more moderate deceleration in the rate of growth of broad money supply was due to a siginificant recovery in the growth of quasi money. Quasi money which recorded a modest growth of Rs.2,315 million or 7 per cent in 1988 increased by a substantial margin of Rs.5,528 million or 16 per cent in 1989. This was fully reflected in the time and savings deposits of other private sector constituents which grew by Rs.6,249 million or 21 per cent.

In sharp contrast to the experience in the previous year when the expansion in M_1 was heavily concentrated in the currency holdings of the public, in 1989 the growth in M_1 was mainly reflected in the demand deposit component which increased by Rs.1,796 million or 13 per cent. Consequently, the share of the currency component in M_1 declined from 57 per cent in 1988 to 56 per cent in 1989. This drop in the currency component in the money supply may be intepreted as a reduction in the preference of the public to hold liquid cash for transactions purposes following the improved civil conditions in the country, particularly during the last quarter of 1989.

A substantial drop in the rate of growth of domestic credit was the major underlying factor for the deceleration in the rate of growth of the money supply in 1989. Compared with the sharp increase of Rs.21,302 million or 28 per cent in 1988, domestic credit expanded by only Rs.5,454 million or 6 per cent in 1989. Both the government sector and the private sector utilised significantly lower amounts of bank credit during the year. In sharp contrast to the developments in 1988 when net credit to government (NCG) from the banking system increased by Rs.9,017 million or 33 per cent, in 1989 such credit expanded by a mere Rs.54 million. Following a similar trend, gross credit to the private sector (GCPS) increased by only Rs.5,400 million or 9 per cent during 1989 compared with a rise of Rs.12,285 million or 25 per cent in the previous year.

One of the most welcome developments in the sphere of bank credit in 1989 was a very sharp drop in the magnitude of bank credit utilised by the Government for budgetary purposes. Although its borrowing requirements remained high, the Government was able to obtain a large bulk of its credit requirements from the non bank private sector largely due to the intensified activities in the Treasury bill market. In all, gross credit to Government from the banking system rose by only Rs.429 million during 1989, as compared with an increase of Rs.12,792 million in 1988. This, together with a deposit build-up of Rs.375 million, reduced the net recourse to the banking system on the part of the Government to a negligible Rs.54 million during the year. This was one of the most salutory developments from the stand point of achieving stabilisation objectives and containing inflationary pressures in the economy. During the last few years, the Central Bank Annual Reports had been repeatedly drawing the attention of the Government to the need for fiscal restraint as its continued heavy borrowings from the banking system constituted the major underlying factor for the excessive liquidity creation in the economy exerting heavy pressure on the money supply, prices and the balance of payments.

In a parallel development to that of the Government, the growth of credit to private sector too recorded a significant deceleration in 1989. The volume of credit utilised by the "other private sector constituents" (private sector proper) from the banking system increased only by Rs.2,465 million 5 per cent during the year, as compared with a growth of Rs.8,669 million or 22 per cent in 1988. The reduced usage of bank credit by the private sector could be attributed partly to the restrictive monetary policy that was in operation during the year and partly to the slack demand for credit from the private sector in the midst of continuing unsettled conditions in the country.

Meanwhile, commercial bank credit to government corporations expanded by Rs.3,075 million or 29 per cent in 1989. This was largely due to a higher demand for credit for meeting working capital requirements of some corporations where the cash flows had been disrupted by sporadic incidents of violence. The enhanced role of the Co-operative Wholesale Establishment (C.W.E.) as an importer of essential food stuffs following the transfer of food import responsibilities from the Food Commissioner to the C.W.E. also contributed to raising the level of bank credit to this sector. During 1989, advances to the C.W.E. rose by Rs.1,269 million while those to the two state plantation corporations increased by Rs.1,189 million. Meanwhile, credit to co-operative institutions dropped by Rs.140 million during 1989 in contrast to an increase of Rs.195 million in the previous year.

For the second consecutive year, the operations of the external sector exerted a contractionary impact on the money supply in 1989. Altogether, the net foreign assets (NFA) of the banking system declined by Rs.2,326 million in 1989. The NFA position showed marked fluctuations during the year. The NFA of the banking system declined drastically from Rs.7,058 million in December 1988 to Rs.976 million in August, 1989, but recovered thereafter to reach Rs.4,732 million by the end of 1989.

In 1989, commercial banks faced stiff competition in mobilising deposits in the context of intensified activities in the short-term money market. Meanwhile, the Central Bank pursued a restrictive monetary policy stance to curb excessive credit creation and ease pressure on the balance of payments. These developments resulted in tight liquidity conditions within the banking system as evidenced by the marked increase in domestic inter-bank borrowings, particularly during the third quarter of the year. The situation may have been exacerbated by the delayed repatriation of export proceeds by some exporters seeeking to benefit from a progressive depreciation of the exchange rate and the practice of some commercial banks to hold unduly large working balances abroad, again to gain from the exchange rate depreciation. The pressure on commercial bank liquidity was somewhat eased during the closing months of 1989, once deposit growth regained its momentum and repatriation of export proceeds assumed its normal course. However, the pressure for short-term funds from deficit banks, as well as the continuing high interest rates in other submarkets, caused the interest rates in the inter-bank call money market to remain high for most times of the year.

In keeping with the stabilisation endeavours during the year, the total assets/liabilities of the Central Bank rose by only Rs.7,439 million or 13 per cent in 1989 compared with an increase of Rs.9,888 million or 22 per cent in the previous year. Another note-worthy feature of Central Bank's asset growth was the fact that a considerable portion of the increase in total assets was reflected in the foreign assets of the Bank. The International Reserve (gross) of the Central Bank recorded an increase of Rs.2,343 million or 31 per cent in 1989, thus reversing a trend observed during the last few years when such assets continued to decline. On the other hand, in sharp contrast to substantial increases recorded in the previous three years, domestic assets of the Bank (excluding other assets and accounts) showed only a marginal growth of Rs.761 million or 2 per cent during 1989. Loans and advances to the Government and investments in government and government guaranteed securities rose only by Rs.302 million in 1989, reflecting a sharp cut-back in the use of Central Bank credit on the part of the Government for budgetary purposes during the year. The corresponding increase in 1988 was Rs.10,282 million. At the same time, Central Bank's short-term loans to commercial banks rose by only Rs.34 million as compared with an increase of Rs.216 million in 1988. In 1989, the large bulk of the increase in domestic assets of the Central Bank was reflected in 'other assets and accounts' of the Bank, which rose by Rs.4,334 million, as compared with an increase of Rs.451 million in 1988.

On the liabilities side, reflecting more favourable stabilisation trends. the monetary liabilities of the Bank grew by Rs.2,344 million or 7 per cent in 1989, as compared with a increase of Rs.10,608 million or 47 per cent in 1988. Currency in circulation increased by Rs.755 million, while deposit liabilities rose by Rs.1,590 million. The corresponding increases in 1988 were Rs.5,308 million and Rs.5,300 million, respectively. One adverse development however was that in 1989 the Central Bank's short-term borrowings from abroad increased substantially by Rs.2.401 million, while other liabilities of the Bank also rose by Rs.2,703 million.

In the context of continuing inflationary pressures, the general level of interest rates continued to remain high throughout 1989. Interest rates in markets more responsive to market forces displayed a greater degree of fluctuation, ending the year at a slightly higher level than at the beginning. In the primary Treasury bill market, interest rates remained largely market determined with only minor interventions by the authorities. The weighted average yield on 12 months Treasury bills rose from 18.8 per cent per annum at the end of June, 1989 to 19.1 per cent per annum by the end of the year, while the weighted average yield on 3 months bills declined from 19.8 per cent per annum to 18.1 per cent annum over the same period. Interests rates in the secondary market for Treasury bills generally responded to variations in rates in the primary market, though the end year rates in this market were slightly lower than at the end of 1988.

Against the background of unsettled conditions, the money market tended to be only moderately active during 1989. The Treasury bills market played a leading role in determining the interest rates and availability of funds in the money market. As a result of the higher yield available in the Treasury bills market, the flow of funds in the inter-bank call money market was significantly reduced thereby tightening the inter-bank call money market interest rate. These, together with the stringent monetary controls which were operative throughout the year, contributed to maintain pressure on short-term interest rates in the market. Meanwhile, following the upward movement in short-term rates, the commercial bank's deposits rates tended to rise in 1989. The minimum and maximum rates on 12 month deposits increased from a range of 9 to 15.5 per cent per annum at the end of 1988 to a range of 11 - 20.5 per cent per annum by the end of December, 1989. Meanwhile, the weighted average prime lending rate of commercial banks was also on a rising trend during the year, reflecting the increased cost of funds for commercial banks, as well as the tight market conditions for short-term funds. The weighted average prime lending rate fluctuated within a range of 16.5 to 18.1 per cent per annum during 1989, compared with a range between 13.6 and 16.9 per cent per annum during the preceding year.

In order to curb the inflationary pressures that existed in 1988 and to cope with the growing payments difficulties that emerged in 1989, the authorities were obliged to pursue an increasingly restrictive monetary policy in 1989. The policy measures implemented during the year include an upward revision of Bank Rate, partial ceiling on commercial bank credit to private sector, a 100 per cent margin requirement against Letters of Credit on non-essential imports and a further intensification of activities in the Treasury bills market. The Bank Rate was raised from 10 to 14 per cent with effect from June 1989, in order to provide a signal to commercial banks as to the direction in which the interest rates should move in the immediate future so as to dampen the demand for credit. With a view to further moderating the rate of expansion of credit, a partial ceiling on credit was imposed on commercial bank credit to non-priority sectors in mid-1989. In terms of this measure, commercial banks were instructed that their outstanding advances which include loans, overdrafts, import bills and local bills financed, should not exceed the level as at May 31, 1989. However, credit facilities to priority sectors, including agriculture, industry, export trade and pre-shipment export bill financing were not restricted. In addition, advances granted under specific credit schemes for productive purposes (SMI Schemes Prajanaya Niyamaka Scheme, Village Adoption Scheme, Self-employment Scheme, etc.) and to long-term credit institutions and the Co-operative Wholesale Establishment for essential food imports were also exempted from the ceiling. In addition to these measures, a 100 per cent deposit margin requirement against Letters of Credit for specified luxury and semi-luxury items was imposed from 15th June, 1989. This was primarily aimed at arresting the worsening balance of payments position that existed in mid-1989.

As regards open market operations, weekly auctions in the primary Treasury bill market were continued thereby providing a regular investment outlet for liquid funds of commercial banks and other investors. In February 1989, in addition to usual three months Treasury bill, bills with maturity periods of six and twelve months were introduced to the market. The availability of Treasury bills with different maturities was expected to provide a better portfolio option to investors, thereby facilitating further development of the money market. In addition, sale of Treasury bills under the "Tap System" introduced in 1986 and limited to regional offices of the Central Bank, was expanded during the year to cover eight commercial banks and three money brokers. During the year, non-Central Bank sources were encouraged to increase their participation in the primary Treasury bill market through newspaper advertisements. In the secondary Treasury bill market, the Central Bank endeavoured to reduce its holdings through intensified sales. Discount and re-discount rates in this market were adjusted to reflect the movement of yields in the primary market for Treasury bills. The gross sales in the secondary Treasury bills market rose by 15.9 per cent as compared with the sales in the previous year. As a consequence to these changes, the holdings of Treasury bills by the non-banking sector more than doubled, from Rs.6.6 billion at the end of 1988 to Rs.15.5 billion at the end of 1989. Meanwhile, the share of holdings of Treasury bills by the Central Bank was reduced from 73 per cent at the end of 1988 to 57 per cent at the end of 1989.

Although the balance of payments and monetary conditions demanded the pursuance of a restrictive monetary policy, the Central Bank continued to provide refinance facilities to productive sectors through commercial banks and development financing institutions for the promotion of short-term and medium-term lendings to priority sectors of the economy.

The total outstanding refinance provided by the Bank on different schemes increased by Rs. 458 million in 1989 to reach Rs. 4,312 million by the end of the year.

The capital market suffered a severe setback during the first three quarters of 1989 but recovered somewhat during the last quarter. With the intensification of civil disturbances and work stoppages during the third quarter of the year, investors avoided the share market and tended to build liquid assets readily encashable. Accordingly, the total turnover in the market during 1989 dropped by a third compared with the previous year. Similarly, reflecting the lower trading activities, the total number of shares traded in the market decreased from 13 million in 1988 to 12 million in 1989.

TABLE 1.5

Monetary Magnitudes 1984 - 1989

Rs. Million

Item	1984	1985	1986	1987	1988	1989
Change in Domestic Credit	633	9,300	4,883	11,457	21,302	5,454
Increase in Net Credit to Govt.	-2,979	5,793	2,198	4,502	9,017	54
Increase in Credit to Govt. Corp	-237	290	301	2,627	3,421	3,075
Increase in Credit to Co-operatives	-255	-263	120	-301	195	-140
Increase in Credit to other Private Sector	4,104	3,480	2,263	4,629	8,669	2,465
Change in Net External Banking Assets	6,796	-768	-3	111	-2,233	-2,326
Change in Total Assets/Liabilities	7,429	8,532	4,880	11,568	19,069	3,128
Increase in Broad Money Supply (M_2)	6,170	4,982	2,451	7,475	9,611	8,487
Increase in Other Liabilities (Net)	1,259	3,551	2,428	4,093	9,458	5,359
Percentage Increases in Monetary Magnitudes						
Percentage Increase in Total Domestic Credit	1.3	18.6	8.2	17.9	28.2	5.6
Percentage Increase in Total Assets and Liabilities	14.2	14.2	7.1	15.8	22.4	3.0
Govt. as a percentage of Total Domestic Credit Increase	-470.4	62.3	45.0	39.3	42.3	0.1
Non Govt.as a percentage of Total Domestic Credit Increase	570.4	37.7	55.0	60.7	57.7	99.9
Percentage increase in:-						
Broad Money Supply (M_2)	16.6	11.4	5.1	14.7	16.4	12.4
Narrow Money Supply (M_1)	14.1	11.5	12.9	18.4	29.1	9.1

Source: Central Bank of Sri Lanka.

The Sri Lankan economy which grew at an average healthy rate exceeding 5 per cent during the first half of the 1980s, started to show signs of being weary thereafter under the impact of continued civil disturbances and natural adversities. The civil disturbances in particular, took a heavy toll on the economy by way of widespread damage to property and the capital stock, and loss of output due to orchestrated work stoppages and prolonged shut-downs. The worst of course was the atmosphere of uncertainty and gloom that surfaced which seriously blunted the initiative and drive for investment and growth. Consequently, the average real growth rate during the period 1986-1988 slumped to 3 per cent. Meanwhile, in a background of continued and sustained fiscal expansion since 1986 with the annual budget deficit exceeding 11 per cent of GDP, the dawning of 1989 witnessed the emergence of major macro imbalances with most indicators imparting distress signals. Some of the worst signals related to such macro variables as the rate of monetary expansion, inflation rate, trade and payment deficits, level of foreign exchange reserves and the import capacity. By the end of 1988, official foreign exchange reserves had fallen to the equivalent of only 6 weeks' imports, while the service payments on the external debt had risen to 28 per cent of exports of goods and services.

Against the background of this economic malaise, the implementation of a comprehensive medium term adjustment programme became imperative in order to address the country's macro economic imbalances. In fact, this was to take the form of a revamping of the adjustment programme already commenced in 1988 which witnessed heavy slippages in that year under the stress of an election year and continuing civil disturbances which made heavy demands on the Budget. The programme basically aimed at stabilising the economy by arresting the deteriorating external payments position, achieving a safe level of fiscal balance and moderating the rate of monetary expansion to a level compatible with a tolerable level of inflation. The main elements of the programme were: (1) Progressive reduction of fiscal deficit by restraining expenditure and improving revenue performance. The overall budget deficit was expected to be reduced to 12.5 per cent of GDP in 1989 and further to 10 per cent in 1990. (2) Containing of the current account deficit to about 10 per cent of GDP in 1989 and to be further reduced to 9 per cent in 1990. (3) Inflation was expected to be limited to about 12 per cent in 1989 and to fall further to 10 per cent by 1990. (4) Correction of domestic cost and price distortions by adjusting administered prices; (5) Restraining of credit growth and reform of the financial sector; (6) Flexible exchange rate management; (7) Public enterprises reform, (8) Reform of the public service to reduce over-staffing. Thus, the programme which included many significant policy thrusts was aimed at regaining macro economic stability with a view to shifting the economy back to its long term growth path. The monetary policy in particular was conducted with an eye on the need to a quick return to monetary and price stability.

The available evidence show that the stabilisation programme had been broadly on track, enabling the restoration of a considerable degree of stability into the economy. The attempts at economic stabilisation received further impetus by the precipitated improvement in the security situation during the closing months of 1989. In the event, most major macro economic aggregates performed as planned or better in 1989. The budget deficit had declined to 10.4 per cent of GDP as against a targetted deficit of 12.5 per cent, while expansionary financing of the budget deficit which was 4.1 per cent of the GDP in 1988 had been totally eliminated. The improvement in the performance of the budget came largely through improved revenue collection, strict controls on government expenditure and the deferment of certain capital expenditure commitments. Meanwhile, the reserve money growth had been maintained at 5 per cent as compared with 33 per cent in 1988. Following this, the annual rate of growth of narrow money supply M_1 which amounted to 29 per cent in 1988 had declined sharply to 9 per cent in 1989, while the rate of growth of broad money supply M_2 recorded a somewhat similar deceleration, from 16 per cent in 1988 to 12 per cent in 1989. The deceleration in the rate of growth of money supply had been brought about mainly through a sharp cut-back in the rate of domestic credit expansion both in favour of the Government and the private sector. While the Government reduced its borrowing requirements through improved cash management and rationalisation of expenditure, the aggressive open market operations policy of the Central Bank enabled the divesting of a significant proportion of its holdings of Treasury bills to non-Central Banking sources. This resulted in a total elimination of bank financing for budgetary purposes in 1989. Meanwhile, temporary quantitative restrictions were imposed on private sector credit for non-essential purposes and this along with the aggressive open market operations policy was instrumental in moderating the rate of growth of credit to the private sector during the year.

The favourable monetary and budgetary developments helped, in turn, to achieve reasonable stability in the balance of payments and prices. While the current account deficit target for the year was 10 per cent of GDP, the improved conditions resulted in a reduced deficit of 9 per cent of GDP in 1989. The gross exernal assets of the banking system increased from Rs. 18.4 billion as at the beginning of the year to Rs. 21.7 billion at the end of 1989 raising the country's import capacity to 3 months' imports. The overall deficit in the balance of payments was reduced to SDR 67 million in 1989 from a much higher targetted deficit of SDR 170 million initially anticipated. The average annual inflation rate which stood at 14 per cent in 1988 was reduced to slightly below 12 per cent in 1989. However, during the last quarter of the year prices of major food items moved up in the market, mainly on account of supply bottlenecks and upward adjustments of certain administered prices to reflect their true costs.

On the whole, the evidence so far is that the economic stabilisation programme has worked generally satisfactorily in 1989. The fact that such stabilisation had to be achieved in the midst of continuing civil disturbances which prevented economies on defence expenditure, on the one hand, and the adverse natural factors which affected agricultural production, on the other, made the stabilisation endeavours much more challenging. It is in this context that the success of the stabilisation programme needs to be viewed. The gains made in 1989 at economic stabilisation should no doubt lay the foundations for steady economic progress during the 1990s.

While progress made in 1989, at economic stabilisation was commendable, there is still considerable more work to be done. For instance, there is a continuing need to pursue fiscal adjustment and structural measures so that the benefits of the stabilisation gains made through fiscal moderation will not be frittered away. The monetary policy will continue to be geared to containing inflation and improving the performance of the external sector. The authorities' goal will be to keep monetary expansion in line with nominal GDP growth at the targetted inflation rate. It is important to create a climate which provides incentives for economic progress by encouraging innovation, saving, and investment. Markets perform these tasks more effectively when people can reasonably believe that by foregoing present consumption they can reap adequate rewards in the future. Higher saving and capital accumulation will enhance productivity and prospects for further development. Inflation insidiously undermines this process. When the inflation rate is excessively high, people tend to put their savings in foreign currencies, commodities or real estate rather than in financial instruments or claims on productive assets that will foster economic activity. Therefore, maintaining the inflation rate at a tolerable level is a matter of paramount importance for maintaining growth momentum in the economy.

Despite some set-backs and against many trying conditions, the Sri Lankan economy has made a commendable start in tackling the country's fiscal and structural problems. A number of further broad-based measures are to be implemented during 1990/91. These measures are expected to further correct the financial imbalances and lay the foundations for a period of sustained economic expansion. In the new strategy, there will be a greater involvement of the private sector in the country's economic development, while also eliciting maximum participation from external sources. While the structural measures have not had much effect so far in terms of investment on account of continuing civil disturbances, with the improvement in the security situation they are likely to generate considerable enthusiasm among investors, both domestic and foreign, in the coming months.