ECONOMIC PERFORMANCE, PROBLEMS AND POLICIES IN 1992

An economic growth rate of 4.3 per cent, sharp expansion in industrial exports, a favourable balance of payments position and significant progress towards fiscal consolidation were among the highlights of Sri Lanka's economic performance in 1992. However, excessive monetary expansion and persistently high price rises remained major areas of concern.

Despite a serious setback to agricultural production, the country posted a real growth rate of 4.3 per cent in 1992, thus maintaining the growth momentum ushered in 1990. Buoyed by a rapidly expanding textile and garments sector, the earnings from industrial exports rose by 37 per cent during the year. In the balance of payments, there was an overall surplus of SDR 129 million in 1992, the third successive year to record a surplus. There was also significant progress towards fiscal consolidation with the budget deficit declining to 7.4 per cent of GDP in 1992 from 11.6 per cent in 1991. However, the year-on-year increase in money supply was 17 per cent in 1992 while the annual average increase of consumer prices was 11.4 per cent.

Despite the setback to agricultural production due to a prolonged drought, the Sri Lankan economy posted a reasonably high growth rate in 1992. The Gross Domestic Product (GDP), in real terms, is estimated to have increased by 4.3 per cent in 1992. Meanwhile, the Gross National Product (GNP), which is derived by allowing for the net factor income from abroad, showed a growth of 4.4 per cent, compared with 4.6 per cent in 1991.

TABLE 1.1

National Income Statistics 1990 – 1992

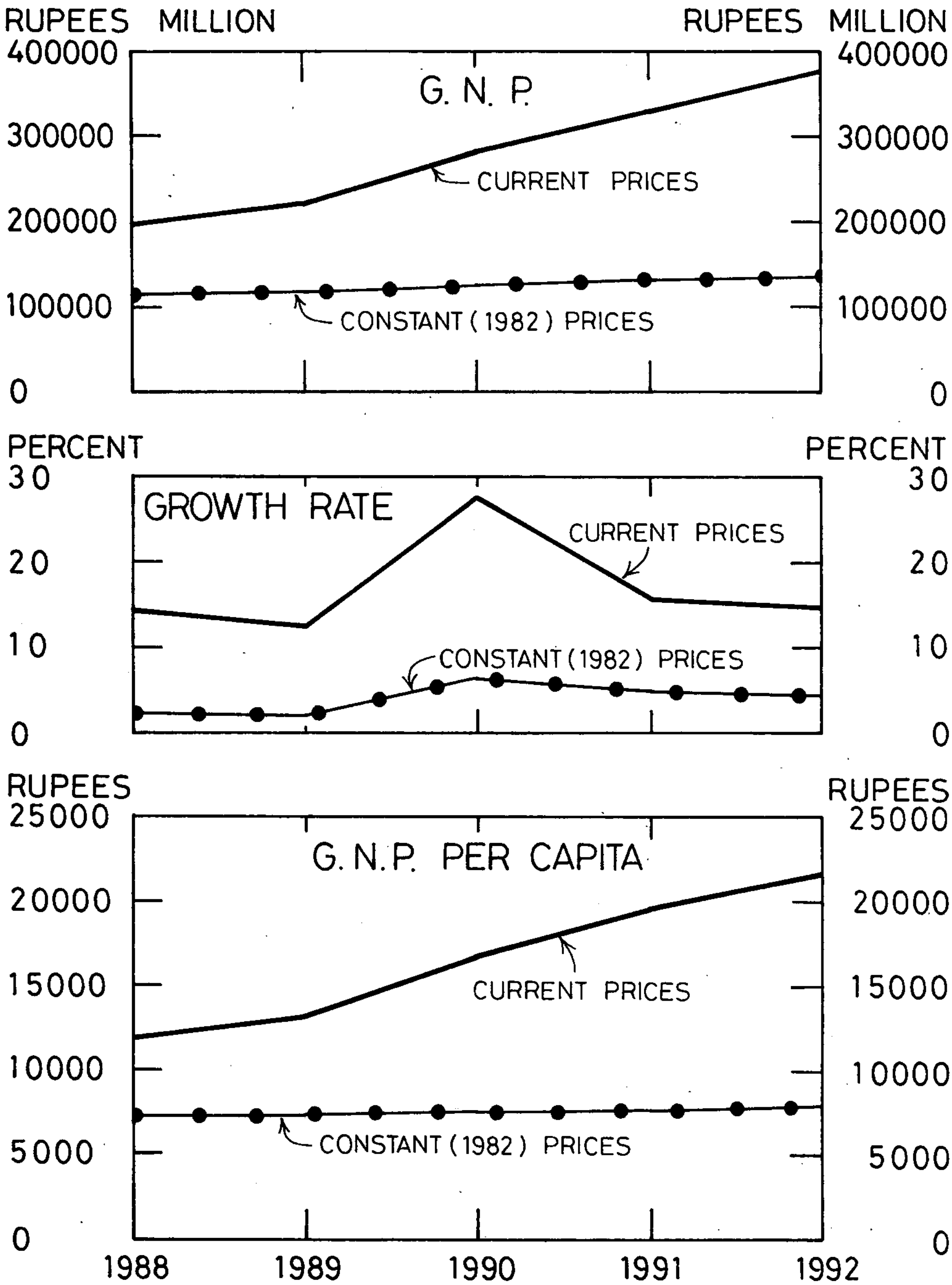
Item	Amount (Rs. Million)			Growth Rate	
	1990*	1991*	1992*	1991*	1992*
1. GDP at Current Factor Cost Prices	290,479	335,356	384,354	15.4	14.6
2. GDP at Constant (1982) Factor Cost Prices	129,244	135,204	140,960	4.6	4.3
3. GNP at Current Factor Cost Prices	283,794	327,989	376,660	15.6	14.8
4. GNP at Constant (1982) Factor Cost Prices	126,426	132,214	138,097	4.6	4.4
5. Mid Year Population ('000)	16,993	17,247	17,405	1.5	1.0
6. GNP Per Capita					
i. At Current Prices (Rs.)	16,701	19,017	21,641	13.9	13.8
ii. At Constant Prices (Rs.)	7,440	7,666	7,934	3.0	3.5

* Provisional

Source : Central Bank of Sri Lanka

Note : Values for 1992 are based on available Customs data.

GROSS NATIONAL PRODUCT



Central Bank of Sri Lanka

The GDP growth in 1992, though considerably lower than the growth rate of 6.2 per cent recorded in 1990, was commendable considering the inhospitable international and domestic conditions facing the country. In the international scene, there was lingering recession in many industrial countries which had a depressing impact on the demand for most primary commodities. On the domestic front, the prolonged drought that prevailed during the early part of the year caused agricultural production to decline. In this context, the 1992 growth performance, though moderate, underscores the strong resilience of the economy in the wake of the continued reforms and liberalisation efforts to promote economic growth and development.

The GNP at current factor cost prices had been estimated at Rs. 377 billion in 1992, an increase of 14.8 per cent over the previous year. Meanwhile, the GNP at constant (1982) factor cost prices was estimated at Rs. 138 billion, reflecting a growth of 4.4 per cent over the previous year. Accordingly, the implicit GNP deflator, which is a measure of overall price changes in the economy, had been estimated at 10.0 per cent in 1992.

According to provisional estimates of the Registrar General, Sri Lanka's mid-year population in 1992 has been estimated at 17.41 million. Thus, the per capita GNP at current prices had been estimated at Rs. 21,641 (US.$494) in 1992. This was an increase of 13.8 per cent over the previous year. The increase in per capita GNP in real terms was 3.5 per cent in 1992.

The country's Gross Domestic Savings had been estimated at Rs. 65 billion in current terms and as a ratio of GDP at current market prices, domestic savings increased from 12.7 per cent in 1991 to 15.3 per cent in 1992. Meanwhile, the national savings ratio - the ratio of national savings to GDP at market prices - increased from 15.2 per cent in 1991 to 18.3 per cent in 1992.

TABLE 1.2

Composition and Growth Rate of GNP 1990 – 1992 at Constant (1982) Factor Cost Prices

Item	Amount (Rs. Million)			Growth Rate		
	1990*	1991*	1992*	1990*	1991*	1992*
1. Agriculture, Forestry & Fishing	30,011	30,570	30,112	8.5	1.9	-1.5
of which						
1.1 Tea	3,004	3,100	2,303	12.6	3.2	-25.7
1.2 Rubber	718	655	662	3.0	-8.8	1.1
1.3 Coconut	3,261	2,827	3,018	1.6	-13.3	9.0
1.4 Paddy	6,378	6,002	5,882	21.3	-5.9	-2.0
1.5 Other (other Agriculture, Forestry & Fishing)	16,650	17,986	18,184	5.2	8.0	1.1
2. Mining & Quarrying	3,901	3,511	3,300	9.1	-10.0	-6.0
3. Manufacturing	22,427	23,949	26,106	9.5	6.8	9.0
3.1 Tree Crop Processing	3,530	3,332	2,959	8.4	-5.6	-11.2
3.2 Other	18,897	20,617	23,147	9.7	9.1	12.3
4. Construction	8,761	9,033	9,665	2.9	3.1	7.0
5. Services	64,144	68,141	71,777	4.3	6.2	5.3
6. G.D.P.	129,244	135,204	140,960	6.2	4.6	4.3
7. Net Factor Income from Abroad	-2,818	-2,990	-2,863	–	–	–
8. G.N.P.	126,426	132,214	138,097	6.4	4.6	4.4

* Provisional

Source : Central Bank of Sri Lanka

Note : Values for 1992 are based on available Customs data.

The rate of capital formation further improved, though marginally, in 1992. The ratio of Gross Domestic Capital Formation (GDCF), inclusive of changes in stocks, to GDP at current market prices increased from 22.9 per cent in 1991 to 23.7 per cent in 1992. Following the pattern observed in recent years, the private sector continued to be the major participator in capital formation. The capital formation in the private sector grew by 21.7 per cent in 1992, a rate higher than that in 1991. Construction, both residential and non-residential, transport equipment and plant and machinery were the key areas of investment by the private sector. Meanwhile, the rate of growth of capital formation in the Government sector declined drastically from 25.4 per cent in 1991 to 1.9 per cent in 1992.

An analysis of the sectoral growth performance has revealed that the main growth sectors in the economy in 1992 had been the manufacturing and services sectors. In contrast, the agricultural and mining sectors had recorded negative growth. Maintaining the growth momentum displayed in recent years, the manufacturing sector provided a strong impetus to economic growth in 1992 contributing over a third of the increase in GNP during the year. The manufacturing sector as a whole recorded a growth of 9 per cent in real terms following the growth rate of 6.8 per cent in 1991. Within the manufacturing sector, the value added in factory industry, the main component of which being the export-oriented textiles and garments industry, expanded by 13 per cent in real terms. The small industry sub-sector is estimated to have grown by 8 per cent in 1992. The continued dynamism of the manufacturing sector in determining Sri Lanka's growth performance in recent years, underscores the growing structural changes that had occurred in the economy in response to economic reforms and liberalisation measures.

The services sector - the other major sector which contributed to maintain the growth momentum during 1992 - expanded by 5.3 per cent in 1992, compared with a growth rate of 6.2 per cent in 1991. Within this sector, transport, communications, trade and banking and financial services, all recorded increased growth. The transport, storage and communications sector recorded a growth of 6 per cent while the wholesale and retail trade sector posted an overall growth of 5.8 per cent. The expansion in the wholesale and retail trade sector accounted for approximately 28 per cent of the total increase in GNP in 1992.

For the second consecutive year, the agriculture, mining and quarrying sector recorded poor performance in 1992. In view of the relatively high weight of this sector in the GDP, this decline had a considerable adverse impact on the overall GDP growth rate in 1992. In particular, the production of agricultural crops suffered a severe setback during the year. The value added in the plantation sector as a whole declined by 8.1 per cent in 1992, while the contributions from paddy, sugar cane and subsidiary food crops also declined.

Under the impact of a prolonged drought that prevailed during the early part of the year, which affected tea, paddy and sugar-cane production, the agricultural sector displayed lack-lustre performance in 1992. Tea production recorded a sharp decline of 26 per cent, while paddy production also decreased by 2 per cent over the previous year. Meanwhile, rubber production rose marginally by 1 per cent, while coconut production registered an increase of 9 per cent, albeit from a drought affected low base in the previous year. Among subsidiary food crops, products such as big onions, red onions and potatoes recorded substantial increases, while sugar production registered a 10 per cent decline in 1992.

An important structural change in the agricultural sector effected during the year was the privatisation of the management of tea, rubber and coconut plantations owned by the government. Altogether, 449 state-owned plantations, out of a total of 502, were handed over to 22 private management companies. These included 356 tea estates consisting 94,541 hectares of tea. The objective of the privatisation of management was to upstage the commercial viability of this vital sector by raising productivity, improving quality and reducing overhead expenditures.

In 1992, tea production declined drastically by 26 per cent to 179 million kgs. from a peak level of 241 million kgs. recorded in the previous year. Tea production in 1992 was the lowest ever on record since 1956. The prolonged drought that prevailed in the early part of the year was the major contributory factor for this sluggish production performance. The decline in tea production was reflected in all three elevational categories. The output of low-grown teas decreased by 25 per cent, from 116 million kgs. in 1991 to 87 million kgs. in 1992. The production of high and medium-grown teas also declined by 27 per cent and 26 per cent to 54 million kgs. and 38 million kgs., respectively. The output of CTC (cut, tear and curl) teas, which had been rising steadily in the recent past, too recorded a decrease of 23 per cent to 5.1 million kgs. in 1992.

Following a setback to production, the quantity of tea sold at the Colombo Auctions decreased sharply by 24 per cent to 173 million kgs. in 1992. Meanwhile, tea prices at the Colombo Auctions, which had reached dismal levels in 1991, failed to recover to any significant extent in 1992. Accordingly, the average gross price of all teas at the Colombo Auctions increased only marginally by 6 per cent, from Rs. 58.27 per kg. in 1991 to Rs. 61.75 per kg. in 1992. However, in real terms, this was a decline of 2 per cent, from SDR 1.02 per kg. in 1991 to SDR 1.00 per kg. in 1992, which meant that the entirety of the price increase in rupee terms was attributable to exchange rate depreciation. Meanwhile, the average export (fob) price of tea also declined by 3 per cent from Rs. 84.03 per kg. in 1991 to Rs. 81.50 per kg. in 1992. In real terms, this was a decrease of 10.8 per cent, from SDR 1.48 per kg. to SDR 1.32 per kg. between the two years.

Under the impact of a very substantial decrease in yield, on account of unfavourable weather conditions, the cost of production (COP) of tea recorded a sharp increase in 1992. Thus, the average COP of made-tea in 1992 has been estimated at Rs. 72.26 per kg., showing an increase of 19 per cent over the COP in the previous year.

Reflecting continued lack of dynamism, rubber production in 1992, provisionally estimated at 105 million kgs., registered a marginal increase of 1 per cent over the previous year. The level of rubber production in 1992 was significantly lower than the recent peak production of 142 million kgs. recorded in 1984. The drought conditions that prevailed in the early part of the year followed by heavy rains during June and July, shortage of tappers in some producing areas and the diversification of certain uneconomic rubber lands into other crops in the Wet Zone were some of the factors contributing to poor production performance in 1992.

The average price of RSS 1 at the Colombo Auctions rose by 24 per cent to Rs. 29.28 per kg., while the average price of RSS 2 increased by 26 per cent to Rs. 28.89 per kg. in 1992. However, the average export (fob) price of all grades of rubber recorded only an increase of 9 per cent, from Rs. 34.55 per kg. in 1991 to Rs. 37.65 per kg. in 1992. In real terms, the average (fob) price remained unchanged at SDR 0.61 per kg.

between the two years, once again confirming the fact that the higher rupee price was the outcome of exchange rate depreciation. Meanwhile, the cost of production (COP) of rubber in the private sector including smallholdings is estimated to have increased by 7 per cent, from Rs. 19.11 per kg. in 1991 to Rs. 20.50 per kg. in 1992.

Maintaining the progressively increasing trend due to the expansion of the local rubber based manufacturing sector, the domestic consumption of rubber recorded an increase of 6 per cent to 28.5 million kgs. in 1992. This represented 27 per cent of the total rubber production during the year.

In contrast to a decline of 14 per cent in 1991, coconut production registered an increase of 9 per cent to 2,380 million nuts in 1992. The improved coconut output could be attributed to the lagged effect of the comparatively favourable weather conditions that prevailed in 1991. Among the major coconut products, the nut equivalent of DC production rose by 9 per cent, from 335 million nuts in 1991 to 365 million nuts in 1992, while that of coconut oil increased by 32 per cent, from 260 million nuts to 344 million nuts between the two years. However, the nut equivalent of copra exports recorded a decline of 26 per cent to 28 million nuts, while fresh nut exports also decreased by 4 per cent to 23 million nuts in 1992.

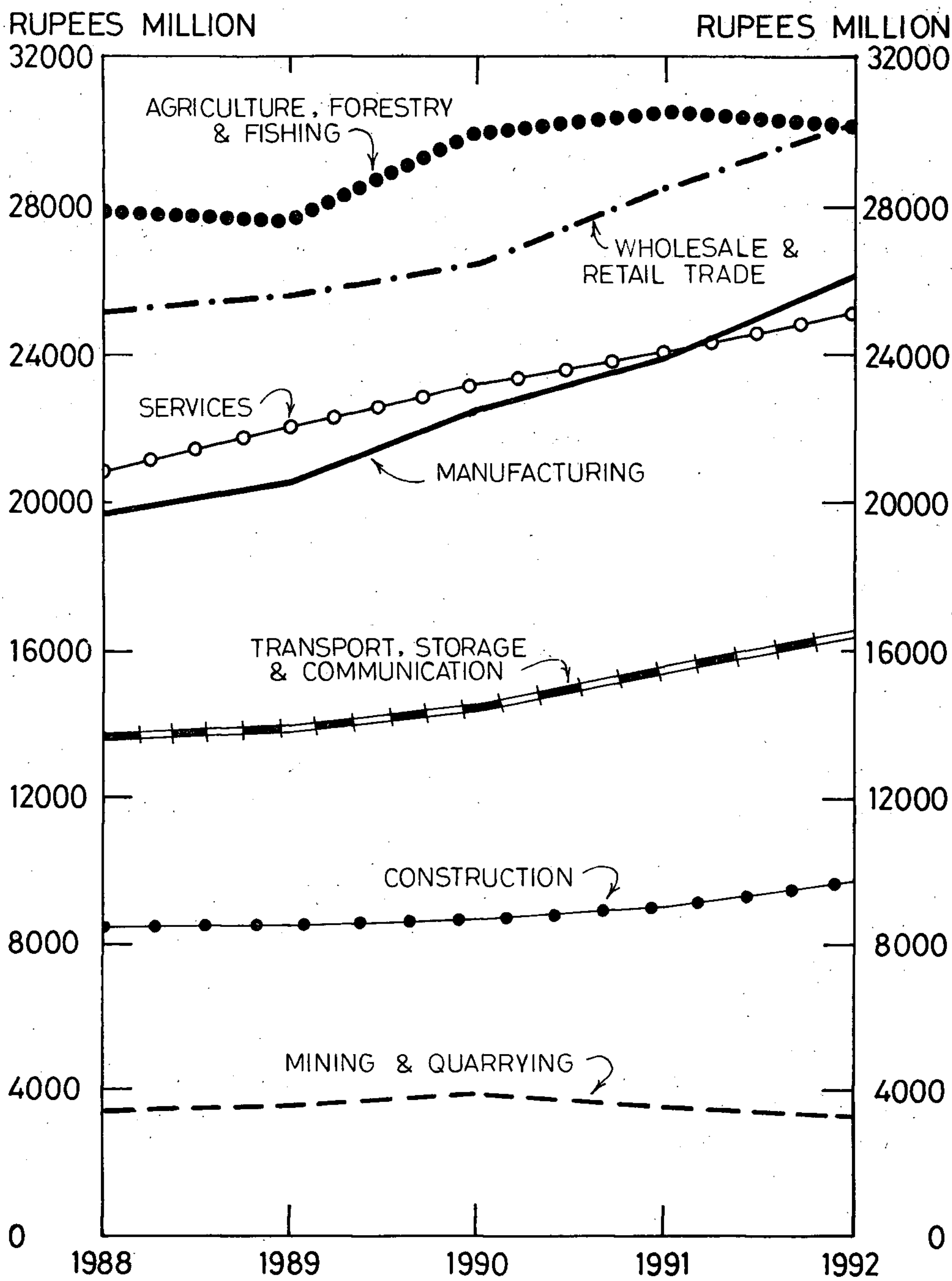
The average export price of the 3 major coconut kernel products, which rose by 33 per cent in the previous year, recorded a further increase of 46 per cent, from Rs. 4.54 per nut in 1991 to Rs. 6.61 per nut in 1992. At the same time, the average price of fresh coconut at the Colombo market which rose by 57 per cent in 1991 increased by a further 33 per cent to Rs. 4.25 per nut in 1992. Meanwhile, the average cost of production per nut in 1992 estimated at Rs. 1.97 showed an increase of 16 per cent.

A noteworthy development relating to the three traditional plantation crops of tea, rubber and coconut in 1992 was the radical change in policy with respect to export taxation. The export duties on these crops, having been revised downwards during the year, were completely abolished with effect from December 22, 1992. Considering the fact that historically these three plantation crops had been a major source of revenue to the government, the 1992 policy change of complete exemption from export duties no doubt marked a fundamental change in fiscal linkages within the domestic economy. It may be recalled that as late as 1978 export duties on plantation crops contributed as much as 40 per cent of the total tax revenue of the government. Its complete abolition in December, 1992 as a source of tax revenue to the government should be considered as the end of an era in which the plantation economy of Sri Lanka was inextricably linked to the government budget. Put differently, the December 1992 change marked the cessation of one of the most closest financial bonds that existed between the plantation economy and government finances in Sri Lanka. Thus, the great debate that had been continuing for several decades about the appropriateness or otherwise of taxing the plantation sector to defray government expenditure will now go on hold, at least for the time being.

Paddy production estimated at 2.3 million metric tons (112 million bushels) in 1992 was a reduction of 2 per cent over the previous year. The decrease in production was, however, wholly confined to the Yala 1992 season, which posted a 15 per cent drop in production. In contrast, paddy production in Maha 1991/92 estimated at 1.63 million metric tons (78 million bushels) was an increase of 5 per cent over the output of the previous Maha season. While the growth in paddy output in the Maha season was mainly

GROSS DOMESTIC PRODUCT BY INDUSTRIAL ORIGIN

AT CONSTANT (1982) FACTOR COST PRICES



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due to an increase in the extent sown and harvested, the decrease in the Yala production was both due to a reduction in the extent sown and harvested, as well as the drought conditions that prevailed during the early part of the year.

Domestic sugar production, which reached a peak level of 66,450 metric tons in 1991, decreased by 10 per cent to 59,700 metric tons in 1992. The severe drought conditions that prevailed during the year reduced the availability of cane for crushing, resulting in a considerably lower output. The decline in production was mainly reflected in a 22 per cent drop in output at Pelwatte, from 43,964 metric tons in 1991 to 34,217 metric tons in 1992 and a 7 per cent decrease in production at Kantalai, from 2,558 metric tons to 2,387 metric tons between the two years. In contrast, however, the production at Sevanagala rose by 27 per cent to 13,576 metric tons due mainly to a 57 per cent expansion in the extent harvested, while that at Hingurana increased marginally by 2 per cent to 9,520 metric tons. In 1992, the Sevanagala factory accounted for 23 per cent of the total sugar production in the country. The sharp decline in the output of Pelwatte was attributed to a substantial decrease of 27 per cent in the quantity of cane available for crushing in 1992 and was very largely due to a sharp drop in the quantity of cane supplied by private growers.

According to available export data, the production of most minor export crops had increased in 1992. The export of cinnamon, which accounted for the largest share of total minor export crops, recorded a 2 per cent increase to 10,408 metric tons in 1992. Meanwhile, the volume of coffee, pepper and clove exports also increased by 8 per cent, 9 per cent and 7 per cent, respectively. However, the export volume of cocoa recorded a decrease of 3 per cent during the year.

According to data provided by the Ministry of Agricultural Development and Research, the performance of the minor food crops sector during 1992 had been somewhat mixed. The production of big onions, red onions, kurakkan and potatoes recorded increases of 28 per cent, 13 per cent, 10 per cent and 9 per cent, respectively, over the previous year. Meanwhile, the production of green gram, soya bean, chillies, gingelly and black gram had recorded decreases of 35 per cent, 30 per cent, 29 per cent, 28 per cent and 19 per cent, respectively. The substantial decline in the output of these crops was due both to reduced average yield and lesser extents under cultivation.

In 1992, the industrial sector continued to show dynamism as the main growth sector of the economy,posting both higher levels of production and exports. The value of industrial output which grew by 10 per cent in real terms in 1991, expanded by a further 12 per cent in 1992. However, once again the growth in industrial production was wholly concentrated in private sector industry. In all, the output of private sector industries increased by 20 per cent in real terms - the highest rate of growth recorded since 1985. In contrast, the output of public sector industry decreased by 19 per cent.

The industrial sub-sectors that recorded production increases in 1992 were: textile, wearing apparel and leather products (31 per cent); non-metallic mineral products (20 per cent); wood and wood products (15 per cent); paper and paper products and basic metal products (14 per cent each); fabricated metal products (9 per cent) and food, beverages and tobacco (1 per cent). The only sub-sector which recorded a decrease in output was chemicals, petroleum and plastic products (5 per cent).

In the private sector which posted a 20 per cent increase in output in real terms, the product categories which showed high rates of growth were: textile, wearing apparel and leather; chemical, rubber and plastic products, and non-metallic mineral products. Meanwhile, the food, beverages and tobacco sub-sector in private sector industry recorded poor production performance in 1992 partly due to the prolonged drought that prevailed during the early part of the year. It was reflected largely in such product areas as tobacco, sugar, liquor and dairy products.

Following the pattern observed in recent years, the public sector industrial output decreased by 19 per cent in 1992 in real terms. The decline in the public sector industrial output in 1991 was 8 per cent. The sharp drop in public sector industrial output in 1992 was the combined outcome of the privatisation of a number of important public sector industrial enterprises and a substantial decrease in output of the Ceylon Petroleum Corporation (CPC) which accounted for approximately 65 per cent of the total public sector industrial output.

The public sector industrial enterprises which recorded decreases in output were: State Rubber Manufacturing (40 per cent), Ceylon Petroleum (18 per cent), Ceylon Mineral Sands (34 per cent) and Lanka Ceramics (3 per cent). The substantial decline in output of the CPC was mainly due to the closure of its refinery for 14 weeks in the second half of 1992 on account of a major modification to the crude distiller unit.

The budgetary transfers to public sector industrial enterprises amounted to Rs. 74 million in 1992 which was an increase of 61 per cent over the transfers made in the previous year. The beneficiaries of these transfers were the National Textile Corporation and the National Paper Corporation receiving Rs. 42 million and Rs. 32 million, respectively.

The Board of Investment of Sri Lanka (BOI) which functions as a "One-Stop Investment Promotion Centre" continued to provide a wide range of incentives and concessions to investors. The BOI approved 291 projects in 1992, under Section 17 of the GCEC Law (special incentive scheme) bringing the total number of projects approved to 702 by the end of 1992. Of these, agreements in respect of 398 projects had been signed with the BOI to set up industries. A total of 211 enterprises were in commercial operation at the end of 1992 as compared with 153 at the end of 1991. Of the projects in operation, 79 were in the Katunayake Investment Promotion Zone (KIPZ), 38 in the Biyagama Investment Promotion Zone (BIPZ), 8 in the Koggala Investment Promotion Zone (KgIPZ) and 86 in other parts of the country. In 1992, the employment in BOI enterprises increased by 22 per cent, bringing the total number of employees in these enterprises to 104,220. Of these, 62,280 or 60 per cent were in the textile, wearing apparel and leather products sector.

The continued presence of price pressure in the economy was a matter for concern in economic management during 1992. The average annual rate of increase of the Colombo Consumers' Price Index (CCPI) was 11.4 per cent in 1992 in comparison to 12.2 per cent in 1991. Meanwhile, on a year-on-year basis (*i.e.* December 1992 over December 1991), the Index at the end of the year showed an increase of 13.8 per cent, compared to a growth of 9.0 per cent in 1991. At the primary market level too, the presence of price pressure was evident with the annual average of the Wholesale Price Index (WPI) rising by 8.8 per cent compared to 9.2 per cent in 1991.

The growth in consumer prices in 1992 was caused mainly by the increases in the food category, particularly towards the end of the year. The rise in the prices of food contributed 73 per cent of the overall increase, while the contributions from clothing, fuel and light, and miscellaneous categories were 3.3 per cent, 2.7 per cent and 21.0 per cent, respectively. The sub-index for food, which has a very heavy weight of 61.9 per cent in the index, increased by 11.9 per cent in 1992.

The increases in the sub-indices for clothing and fuel and light in 1992 were considerably lower than in 1991. The rise in the sub-index of clothing was 6.7 per cent in 1992 as compared to an increase of 11.2 per cent in 1991. Meanwhile, the sub-index for fuel and light rose by 3.6 per cent compared to a 16.5 per cent expansion in 1991. A comparatively large increase of 15.1 per cent was observed in the sub-index for the miscellaneous category in 1992. In this category, significant increases were recorded in liquor and tobacco prices, caused partly by upward revisions in excise taxes and the defence levy.

The presence of price pressure in the economy in 1992 was also reflected at the primary market level with the Wholesale Price Index (WPI) rising by 8.8 per cent as compared with an increase of 9.2 per cent in 1991. On an year-on-year basis, the index rose by 8.0 per cent in December 1992 in comparison to 8.1 per cent an year ago. Once again, the increase in the WPI was largely reflected in food prices with the food sub-index rising by 10.9 per cent in 1992 compared with 8.3 per cent in 1991. The rise in the food sub-index was largely due to increases in the prices of paddy, coconut, coconut oil, vegetables and fish.

In 1992, growth in the wages of government sector employees, as measured by the Wage Rate Index, was slower than in 1991. In fact, wage increases were insufficient to compensate for rising prices and the real wages of all categories of government sector employees declined during the year. Overall, nominal wages for all Central Government Employees rose by 4.3 per cent in 1992, in comparison to a 12.1 per cent increase in 1991. Accordingly, the real wage index of Central Government Employees declined by 6.4 per cent in 1992, whereas in 1991, the real wage index remained unchanged. The nominal wage rate index of Government School Teachers rose by 3.8 per cent in 1992, but the real wage rate index declined by 6.8 per cent.

In the Organised Private Sector, which comprises trades covered by Wages Boards, the minimum wage rates applicable to a number of trades in the Wages Boards increased in 1992. Overall nominal wages for all trades covered by the Wages Boards rose by 13.7 per cent in 1992 compared with an increase of 14.4 per cent in 1991. With a lower increase in the price level, the overall Real Wage Index rose by 2.1 per cent in 1992 as compared to a 2.0 per cent increase in 1991.

According to provisional estimates, employment in the private sector recorded a significant increase, while employment in the public sector continued to decline in 1992. The total employment in the public sector estimated at 1,288,337 by the end of 1992 was a decline of 1.4 per cent over the previous year. To a large extent, this decrease reflects a re-classification by public sector employees under the private sector following the privatisation of state-owned institutions. Employment in government institutions which included Central Government Ministries and Departments as well as the Provincial Government and Local Government sub-sectors was estimated to be 653,959 at the end of 1992 registering a marginal increase of 0.2 per cent over 1991. Meanwhile, following a trend observed in recent years, employment in the semi-government sector which included public corporations, statutory boards, government-owned business undertakings and state banks registered a decline of 3.1 per cent over 1991.

In the absence of time series data on employment in the private sector, other indicators such as employees registered with provident funds were used to assess the level of employment in the Organised Private Sector. The number of active accounts with the EPF increased from 1,267,835 in 1990 to 1,341,086 in 1991, reflecting an increase of 5 per cent. Meanwhile, the total private sector employment coming under approved provident funds was estimated to have increased by 10 per cent in 1992. Thus, in continuation of a trend observed in recent years, employment in the private sector has shown significant growth in 1992. At the same time, employment in enterprises operating under the Board of Investment of Sri Lanka continued to expand during 1992. The total number of employees in these enterprises at 104,220 at the end of 1992 reflected an increase of 22 per cent over 1991.

Impressive export performance, reduced deficits on both trade and current accounts, increased flow of foreign private capital and a large overall surplus for the third consecutive year were among the highlights of Sri Lanka's balance of payments performance in 1992. A 20 per cent increase in export earnings against a 10 per cent expansion in import expenditure resulted in the trade deficit declining from SDR 726 million in 1991 to SDR 686 million in 1992. Meanwhile, the services account too registered a significant improvement, the deficit declining from SDR 66 million to SDR 20 million between 1991 and 1992. These favourable developments together with increased net inflows on account of private transfers resulted in the current account deficit declining from SDR 352 million in 1991 to SDR 246 million in 1992. The improved current account position was juxtaposed on a favourable capital account, particularly with respect to private foreign capital flows, to generate an overall surplus of SDR 129 million in the balance of payments with consequent additions to the country's foreign exchange reserves.

Under the impact of a sharp growth in exports and a comparatively slower increase in imports, the deficit on trade account narrowed in 1992. This was in sharp contrast to the experience in 1991 when the trade account recorded an expanded deficit following three years of progressive decreases. In 1992, the value of merchandise exports increased substantially by 20 per cent to SDR 1,782 million (Rs. 110,052 million) as compared with a marginal growth of 2 per cent in 1991. Meanwhile, the expenditure on imports rose by 10 per cent to SDR 2,468 million (Rs. 152,407 million), as compared with an increase of 13 per cent in the previous year. Accordingly, the deficit on trade account contracted from SDR 747 million in 1991 to SDR 686 million in 1992. At the same time, the ratio of export earnings to import payments which dropped from 74 per cent in 1990 to 66 per cent in 1991, reversed once again to reach 72 per cent in 1992. Meanwhile, the overall price movements of Sri Lanka's exports and imports were favourable, resulting in an improvement in the terms of trade by 3.7 per cent.

According to Customs data, the performance of the export sector in 1992 was mixed. While agricultural exports suffered a serious setback, industrial exports registered a spectacular growth. Aggregate export earnings from plantation crops dropped by 14.6 per cent, while earnings from petroleum products and gems also declined by 23 per cent and 5 per cent, respectively. However, substantially increased earnings were recorded in textile and garment exports, while other industrial exports and minor agricultural exports also showed considerable increases during the year.

According to Customs data, the value of tea exports declined by 24 per cent, from SDR 316 million (Rs. 17,867 million) in 1991 to SDR 241 million (Rs. 14,893 million) in 1992. Decreases in both volume and price contributed to the sharp drop in export earnings. The volume of tea exports decreased by 14 per cent, from 212 million kilograms in 1991 to 182 million kilograms in 1992. Meanwhile, the average export price of tea dropped by 11 per cent, from SDR 1.49 per kg. (Rs. 84.12 per kg.) to SDR 1.33 per kg. (Rs. 81.98 per kg.) between the two years. The price decline was mainly due to depressed world market conditions and a deterioration in quality. Meanwhile, in sharp contrast to a drop of 18 per cent in 1991, the value of rubber exports rose marginally by 2 per cent, from SDR 47 million (Rs. 2,641 million) in 1991 to SDR 48 million (Rs. 2,960 million) in 1992. This was wholly due to a 4 per cent increase in export volume, from 76 million kgs. to 79 million kgs. between the two years. In comparison, the average export price of rubber remained unchanged at SDR 0.61 per kg. over the two years. The continued recessionary conditions in most industrial countries, contributed to keep the the export price of rubber at depressed levels. From among the plantation crops, only coconut showed a considerable degree of dynamism in 1992 with export earnings rising by 30 per cent, from SDR 46 million (Rs. 2,619 million) in 1991 to SDR 60 million (Rs. 3,691) in 1992. Increases in both volume and price contributed to this favourable export performance. The nut equivalent of export volume increased by 12 per cent, from 367 million nuts in 1991 to 412 million nuts in 1992. Meanwhile, the average export price per nut equivalent increased by 11 per cent to SDR 0.10 per nut in 1992. The improved price for coconut in the world market in 1992 was largely the outcome of a sharp decline in production in the Philippines, the major exporter of coconut to the world market.

While the export performance of plantation crops, particularly that of tea and rubber remained poor, the minor agricultural product sector recorded a substantial improvement in 1992. The value of these exports increased by 30 per cent, from SDR 60 million (Rs. 3,409 million) in 1991 to SDR 78 million (Rs. 4,838 million) in 1992. Unmanufactured tobacco and cinnamon accounted for 35 per cent and 31 per cent, respectively of the total earnings from minor agricultural products. Significant increases were also observed in the earnings from fruits, nutmeg and mace, sesame seeds and betel leaves.

Displaying a very high degree of dynamism, the value of industrial exports rose by 37 per cent, from SDR 896 million (Rs. 50,736 million) in 1991 to SDR 1,227 million (Rs. 75,776 million) in 1992. A larger share of the increase was reflected in textile and garment exports which rose by 45 per cent, from SDR 588 million (Rs. 33,261 million) to SDR 852 million (Rs. 52,588 million) between the two years. The aggregate value of other industrial exports including diamonds, food, beverages and tobacco, chemical products and leather and rubber products rose by 32 per cent. Meanwhile, the value of petroleum exports declined by 22 per cent, from SDR 58 million (Rs. 3,289 million) in 1991 to SDR 45 million (Rs. 2,771 million) in 1992 mainly due to a reduction in output following the closure of the refinery for maintenance purposes. At the same time, earnings from mineral exports also recorded a decrease of 2 per cent, from SDR 45 million (Rs. 2,562 million) in 1991 to SDR 44 million (Rs. 2,749 million) in 1992. This was mainly reflected in gem exports which decreased by 5 per cent, from SDR 42 million (Rs. 2,358 million) in 1991 to SDR 40 million (Rs. 2,482 million) in 1992.

Following these developments, the composition of exports underwent considerable change in 1992. The industrial exports category made further progress in consolidating its position as the principal export category, its share rising from 60 per cent in 1991 to 69 per cent in 1992. Meanwhile, the share of agricultural exports which had been declining continuously in the recent past dropped further to 24 per cent in 1992 from 32 per cent in 1991. As a single item, textiles and garments maintained the dominant position, its share increasing from 39 per cent of total exports in 1991 to 48 per cent in 1992.

According to adjusted Customs data, the total expenditure on imports amounted to SDR 2,468 million (Rs. 152,407 million) in 1992 compared with SDR 2,237 million (Rs. 126,643 million) in 1991. The increase was reflected in all three categories of imports - consumer goods, intermediate goods and investment goods. The expenditure on consumer goods rose by 8 per cent, from SDR 572 million (Rs. 32,357 million) in 1991 to SDR 615 million (Rs. 37,995 million) in 1992. The increase was reflected largely in non-food items, which showed a 15 per cent increase over the previous year. In the food and drinks category, expenditure on sugar imports decreased while that on rice imports recorded an increase. The volume of rice imports increased by 77 per cent in the wake of reduced domestic supplies due to the adverse impact of drought. However, the price of rice decreased by 8 per cent thereby containing the import outlay on rice imports at SDR 46 million (Rs. 2,852 million) as compared with SDR 28 million (Rs. 1,589 million) in the previous year. Meanwhile, the volume of sugar imports increased by 3 per cent while the price dropped by 14 per cent, resulting in the import outlay on sugar declining to SDR 80 million (Rs. 4,952 million) in 1992 from SDR 91 million (Rs. 5,139 million) in 1991. In the context of a marginal increase in the import outlay on basic food items, the increased expenditure on consumer goods imports was largely reflected in other consumer goods, the value of which rose by 15 per cent, from SDR 276 million (Rs. 15,607 million) in 1991 to SDR 317 million (Rs. 19,599 million) in 1992. In this category, the items which showed large increases were radio receivers and television sets (18 per cent), rubber tyres and tubes (15 per cent), medical and pharmaceutical products (28 per cent) and other consumer goods (15 per cent).

In 1992, the expenditure on the import of intermediate goods was SDR 1,242 million (Rs. 76,702 million) showing an increase of 9 per cent over the year. The items which showed major increases were wheat and meslin, dyeing and tanning and colouring material and textile, clothing and chemicals. The outlay on wheat and meslin imports increased by 28 per cent, from SDR 58 million (Rs. 3,303 million) in 1991 to SDR 74 million (Rs. 4,549 million) in 1992, while the expenditure on dyeing and tanning and colouring material rose by 56 per cent, from SDR 16 million (Rs. 928 million) to SDR 26 million (Rs. 1,584 million). Meanwhile, reflecting vastly expanded activities in the local textile industry, expenditure on textile and clothing imports increased by 19 per cent, from SDR 364 million (Rs. 20,611 million) in 1991 to SDR 434 million (Rs. 26,794 million) in 1992, while that of chemical products registered an increase of 14 per cent, from SDR 64 million (Rs. 3,643 million) to SDR 67 million (Rs. 4,146 million) between the two years.

The expenditure on investment goods imports increased by 16 per cent, from SDR 526 million (Rs. 29,792 million) in 1991 to SDR 609 million (Rs. 37,596 million) in 1992. Among investment goods, the largest increase was in machinery and equipment, the value of which rose by 33 per cent, from SDR 210 million (Rs. 11,881 million) to SDR 279 million (Rs. 17,200 million) between the two years. During the year, the import outlay on building materials rose by 7 per cent, while the expenditure on transport equipment declined by 4 per cent.

In the services account, there were considerable increases in both receipts and payments, in the wake of continuous liberalisation of foreign exchange restrictions and general expansion of the economy. In the port, transportation and insurance category, the receipts increased from SDR 150 million in 1991 to SDR 157 million in 1992 mainly on account of higher port earnings. Meanwhile, tourist earnings rose by SDR 24 million to SDR 140 million following a 24 per cent increase in arrivals. At the same time, inflows on account of "other" services increased by SDR 10 million to SDR 127 million, while investment income inflows rose from SDR 40 million to SDR 48 million between the two years, reflecting the improved external assets position of the country. The combined impact of these changes was a strengthening of the services account, which together with an improved trade account balance contributed to improve the country's balance of payments position.

Meanwhile, there was a further improvement in the transfers account in 1992 due to enhanced private remittances. Receipts on account of private transfers rose from SDR 323 million in 1991 to SDR 385 million in 1992 registering a 19 per cent increase. Although the outflows on account of transfers also increased from SDR 30 million to SDR 56 million between the two years, on a net basis,the private transfers rose by 12 per cent, from SDR 293 million in 1991 to SDR 330 million in 1992. However, official transfers are estimated to have declined from SDR 148 million to SDR 130 million between the two years. Despite this decrease, the transfers account showed an overall increase of SDR 18 million, the net inflows rising from SDR 441 million in 1991 to SDR 459 million in 1992.

With improved performance on trade, services and transfers accounts, the current account of the balance of payments recorded a reduced deficit of SDR 246 million in 1992, as compared with SDR 352 million in 1991. As a ratio of GDP, the deficit declined from 5.4 per cent to 3.6 per cent between 1991 and 1992. The ratio excluding grants also decreased from 7.6 per cent to 5.5 per cent between the two years. This decline in the current account deficit was one of the most favourable developments in the macro-economic front in 1992 and augurs well for achieving of sustained economic expansion with external sector stability.

In contrast to more widely dispersed improvements in the current account, the developments in the capital account in 1992 were somewhat mixed. One unfavourable development was a decline in non-monetary capital inflows which dropped by SDR 134 million or 28 per cent, from SDR 475 million in 1991 to SDR 341 million in 1992. The decrease was entirely reflected in capital inflows to the government which declined from SDR 486 million to SDR 297 million between the two years. Meanwhile, the amortisation payments on government debts, including settlement of a short-term interim loan of SDR 22 million taken in late 1991, increased from SDR 97 million in 1991 to SDR 146 million in 1992. Thus, on a net basis, capital inflows to the government in 1992 were only SDR 151 million, as compared to SDR 388 million in 1991. In sharp contrast to reduced flows to the government, the capital inflows to private sector continued to grow with greater vigour in 1992 with both direct investments and long-term loans recording considerable increases. Although portfolio investments decreased from SDR 24 million to SDR 18 million between 1991 and 1992, largely due to the depressed conditions in the Colombo Share Market, foreign direct investment in enterprises under the BOI as well as towards acquiring ownership in the recently privatised public enterprises increased from SDR 46 million to SDR 85 million between the two years. Meanwhile, there was also a significant increase in private long-term loan capital to the private sector, the volume rising from SDR 63 million in 1991 to SDR 110 million in 1992. Accordingly, there was a net inflow of private long-term capital of SDR 18 million in 1992 in contrast to an outflow of SDR 18 million in 1991. Furthermore, the net utilisation of private short-term capital rose from SDR 35 million to SDR 69 million between the two years.

Overall, net capital inflows to the private sector were SDR 190 million in 1992 as compared with SDR 87 million in 1991 - an increase of SDR 103 million. In the 1991 Annual Report pointed attention was drawn to the need for attracting private foreign capital to augment the rate of capital formation towards attaining the country's development objectives in the context of a somewhat uncertain future for official capital flows. In this context, the 1992 private capital inflow, though still moderate can be considered as a welcome development.

In the context of a larger volume of resources available in the capital account exceeding the current account deficit, the country's balance of payments registered an overall surplus of SDR 129 million in 1992. This was on top of overall surpluses of SDR 138 million and SDR 152 million recorded in 1990 and 1991, respectively. Meanwhile, Sri Lanka's gross external assets reflected an increase of SDR 238 million or 29 per cent in 1992, raising the outstanding level to SDR 1,047 million at the end of the year. At the

TABLE 1.3

Summary of Balance of Payments 1989 – 1992

Rs. Million (SDR Million in brackets)

Item	1989	1990(a)	1991(a)	1992(b)
Merchandise (Net)	-24,050	-28,145	-41,252	-42,355
	(-530)	(-518)	(-726)	(-685)
Non-Factor Services (Net)	129	2,781	3,594	6,498
	(1)	(51)	(65)	(106)
Factor Services (Net)	-5,738	-6,685	-7,367	-7,694
	(-124)	(-123)	(-130)	(-125)
Private Transfers (Net)	11,840	14,518	16,623	20,369
	(258)	(268)	(293)	(330)
Official Transfers (Net)	6,751	7,142	8,407	8,027
	(147)	(130)	(148)	(130)
Current Account Balance	-11,069	-10,390	-19,995	-15,156
	(-248)	(-192)	(-352)	(-246)
Overall Balance	-1,905	7,480	10,140	9,191
	(-67)	(138)	(152)	(129)
Some Key Indicators				
Terms of Trade (1985 = 100)	91.4	87.4	85.7	88.9
Net Petroleum Imports	6,134	10,393	9,598	11,167
	(133)	(191)	(170)	(180)
Current Account Deficit as a percentage of G.D.P	4.4	3.2	5.4	3.6
Gross International Reserves	23,390	34,472	49,223	66,236
	(447)	(602)	(809)	(1,047)
International Reserves in Months of Imports	3.1	3.7	4.4	5.1

(a) Revised (b) Provisional

Source: Central Bank of Sri Lanka

same time, gross official reserves comprising of foreign assets held by the Central Bank and the government rose from SDR 503 million to SDR 681 million between the two years. Gross external assets at the end of 1992 were sufficient to finance approximately 4.7 months of imports projected for 1993 while gross official reserves were sufficient to finance 3.1 months of imports.

With the exception of the US Dollar and the Japanese Yen, the value of the Sri Lankan Rupee fluctuated against all other major currencies during 1992. This was partly the outcome of the international currency crisis that emerged during the latter part of the year, particularly in Europe. The overall impact of these changes resulted in the Sri Lanka Rupee depreciating against the Japanese Yen by 8.4 per cent, US Dollar by 7.4 per cent, French Franc by 2.3 per cent and the Deutsche Mark by 1.9 per cent. Meanwhile, the Sri Lanka Rupee appreciated against the Pound Sterling by 14.6 per cent between end 1991 and end 1992. Against the SDR, the Rupee depreciated by 3.9 per cent between the two years.

Sri Lanka's total outstanding external debt at the end of 1992 estimated at SDR 5,029 million was an increase of SDR 427 million or 9 per cent during the year. In contrast to the previous year, a large portion of this increase was reflected in the medium and long-term debt of the private sector, in particular the enterprises coming under the BOI, including Air Lanka. The medium and long-term debt of the government rose from SDR 3,594 million to SDR 3,844 million between the two years, mainly due to disbursements of concessional assistance from the ADB and IDA. During the year, the transactions with the International Monetary Fund (IMF) resulted in the outstanding debt to the IMF rising from SDR 280 million at end 1991 to SDR 338 million in 1992. Meanwhile, the outstanding level of short-term debt rose from SDR 350 million to SDR 399 million between the two years.

Sri Lanka's debt service payments which include amortisation of medium and long-term debt and interest payments on all foreign loans increased by SDR 23 million to SDR 379 million in 1992. The increase was reflected entirely in amortisation payments. While amortisation payments had increased by 14 per cent, from SDR 200 million in 1991 to SDR 228 million in 1992, interest payments had declined by SDR 5 million or 3 per cent to SDR 151 million. The increase in amortisation payments was reflected in both the government and the private sector debt. However, although the service payments had increased during the year, the higher earnings from exports of goods and services resulted in the debt service ratio declining from 18.5 per cent in 1991 to 16.7 per cent in 1992. The debt service payments as a ratio of receipts from the export of goods, services and private transfers also decreased from 15.8 per cent to 14.3 per cent between the two years.

The year 1992 saw a series of policy measures aimed at further liberalising the trade and payments system of the country so as to create a more congenial atmosphere for economic activity to take place speedily. With regard to trade, the 100 per cent cash margin requirement on Letters of Credit (L/C) opened for the import of selected items was removed and Authorised Dealers were permitted to sell foreign exchange forward to cover payments on all merchandise imports and services without restrictions. With regard to service payments, foreign exchange allowances for all categories of travel were increased substantially, while entitlements for education and medical treatment overseas were also significantly augmented. With regard to transfer of assets, funds lying in

TABLE 1.4
Summary of Government Fiscal Operations

Rs. Million

Item	1988	1989	1990	1991	1992 Approved Estimate	1992 Provi-sional	1993 Approved Estimate
Total Revenue and Grants	48,337	60,386	74,661	84,049	93,719	94,398	110,927
Total Revenue	41,749	53,979	67,964	76,179	84,999	86,118	101,977
Tax Revenue	35,946	47,513	61,206	68,157	76,591	76,692	94,377
Non-Tax Revenue	5,803	6,466	6,758	8,022	8,408	9,425	7,600
Grants	6,588	6,407	6,697	7,870	8,720	8,280	8,950
Expenditure and Lending minus Repaymets	76,532	82,164	99,814	119,527	124,010	117,627	141,916
Current	46,132	56,884	71,771	83,756	84,327	88,726	97,437
Capital	22,878	20,750	19,161	25,968	34,475	28,540	37,271
Lending minus Repayments	7,522	4,530	8,882	9,803	5,208	361	7,209
Current Account Surplus/Deficit (-)	-4,383	-2,905	-3,807	-7,577	672	-2,608	4,540
Budget Deficit (before grants)	-34,783	-28,185	-31,850	-43,348	-39,011	-31,509	-39,939
Budget Deficit (after grants)	-28,195	-21,778	-25,153	-35,478	-30,291	-23,229	-30,989
Financing	28,193	21,777	25,153	35,478	30,290	23,230	30,989
Foreign Borrowings	7,128	5,926	11,644	19,329	20,793	7,984	19,489
Domestic Borrowings	21,065	12,373	16,986	16,148	9,497	15,246	11,500
Non-Market Borrowings	1,685	1,822	3,538	1,667	0	1,857	0
Market Borrowings	19,380	10,551	13,448	14,481	9,497	13,389	11,500
Non Bank	10,178	11,084	13,190	14,447	9,497	15,710	13,000
Bank	9,202	-533	258	34	0	-2,321	- 1,500
Increases(+) / Decreases(-) in Arrears	0	3,478	-3,478	0	0	0	0

(as a percentage of GDP)

Item	1988	1989	1990	1991	1992 Approved Estimate	1992 Provi-sional	1993 Approved Estimate
Total Revenue and Grants	21.8	24.0	23.2	22.6	21.2	22.3	22.4
Total Revenue	18.8	21.4	21.1	20.4	19.2	20.3	20.6
Tax Revenue	16.2	18.9	19.0	18.3	17.3	18.1	19.1
Non-Tax Revenue	2.6	2.6	2.1	2.2	1.9	2.2	1.5
Grants	3.0	2.5	2.1	2.1	2.0	2.0	1.8
Expenditure and Lending minus Repayments	34.5	32.6	31.0	32.1	28.0	27.8	28.7
Current	20.8	22.6	22.3	22.5	19.0	21.0	19.7
Capital	10.3	8.2	6.0	7.0	7.8	6.7	7.5
Lending minus Repayments	3.4	1.8	2.8	2.6	1.2	0.1	1.5
Current Account Surplus/Deficit (-)	-2.0	-1.2	-1.2	-2.0	0.2	-0.6	0.9
Budget Deficit (before grants)	-15.7	-11.2	-9.9	-11.6	-8.8	-7.4	-8.1
Budget Deficit (after grants)	-12.7	-8.6	-7.8	-9.5	-6.8	-5.5	-6.3
Financing	12.7	8.6	7.8	9.5	6.8	5.5	6.3
Foreign	3.2	2.4	3.6	5.2	4.7	1.9	3.9
Domestic	9.5	4.9	5.2	4.3	2.1	3.6	2.3
Non-Market	0.8	0.7	1.1	0.3	0.0	0.4	0.0
Market	8.7	4.2	4.1	4.0	2.1	3.2	2.3
Non Bank	4.6	4.4	4.1	4.0	2.1	3.7	2.6
Bank	4.2	-0.2	0.1	0.0	0.0	-0.5	-0.3
Increases(+) / Decreases(-) in Arrears	0.0	1.4	-1.1	0.0	0.0	0.0	0.0

Source : Central Bank of Sri Lanka

non-resident blocked accounts to the credit of Sri Lankans who have emigrated were permitted to be released. Moreover, the ceiling on capital transfers at the time of departure for emigrants was raised from Rs. 350,000 to Rs. 500,000 per individual. Meanwhile, investment by non-residents, approved country and regional funds in upto 100 per cent of the issued capital of companies in Sri Lanka, subject to certain conditions was permitted from mid-1992. In addition, different incentive packages to encourage investment, both local and foreign, in different sectors of the economy, were introduced by the Board of Investment in 1992.

The budgetary outturn in 1992 marked a considerable improvement with the deficit recording a substantial decrease, thereby recouping some of the fiscal slippages that occurred in the previous year. Although the overall revenue effort was slightly weakened with a reduction in the revenue/GDP ratio from 20.4 per cent in 1991 to 20.3 per cent in 1992, a sharp fall in current expenditure coupled with a reduction in capital expenditure net of receipts under the privatisation programme, helped in containing the total expenditure/GDP ratio at 27.8 per cent in 1992 as compared with 32.1 per cent in the previous year. This was conducive to generating a reduced overall budget deficit of 7.4 per cent of GDP, a significantly lower ratio compared to 11.6 per cent recorded in 1991. This no doubt should constitute a major step towards fiscal sobriety vital for sustained economic expansion with stability.

Government revenue in 1992 at Rs. 86,118 million was an increase of 13 per cent as compared to a 12 per cent growth in 1991. However, the overall revenue growth lagged behind the increase in nominal GDP registering a slight decline in the revenue/GDP ratio to 20.3 per cent in 1992 from 20.4 per cent in 1991. Tax revenue totalling Rs. 76,692 million accounted for 89 per cent of total revenue - almost the same level as in the previous year. Domestic taxes on goods and services continued to expand during the year generating 51 per cent of tax revenue as compared with 47 per cent in 1991. The increase in the range of products under excise tax and the imposition of a defence levy contributed to enhance revenue from this source. Meanwhile, import duties formed 27 per cent of total revenue in 1992. Conforming to the downward trend observed in recent years, the share of export duties further declined to 1.1 per cent of total tax revenue in 1992. In contrast, the share of income taxes in total tax revenue increased from 14.3 per cent in 1991 to 15.1 per cent in 1992.

In 1992, non-tax revenue at Rs. 9,425 million was an increase of 17 per cent over the previous year. Interest income rose by 35 per cent and accounted for 38 per cent of non-tax revenue. Similarly, the transfer of Central Bank's profits at Rs. 1,150 million in 1992 was higher by Rs. 650 million. Meanwhile, revenue from non-industrial sales, administrative fees and regulatory charges at Rs. 2,505 million accounted for 27 per cent of non-tax revenue.

Total expenditure at Rs. 117,627 million in 1992 was a marginal decrease of 2 per cent over 1991. This constituted Rs. 88,726 million (75 per cent) of current expenditure and Rs. 28,909 million (25 per cent) of capital expenditure and net lending. Although current expenditure in 1992 reflected an increase of 6 per cent over 1991, as a ratio of GDP current expenditure declined from 22.5 per cent to 21.0 per cent between the two years. The outlay on account of goods and services in the form of salaries, wages and other goods and services at Rs. 39,135 million formed the bulk (44 per cent) of current expenditure. In 1992, interest payments on public debt at Rs. 25,283 million accounted for 28 per cent of current expenditure. Of the outlay on interest payments, domestic debt absorbed Rs. 20,597 million and foreign debt Rs. 4,626 million. Meanwhile, transfers to households and selected public corporations and other institutions at Rs. 24,308 million in 1992 was a drop of 6 per cent. As a ratio of total current expenditure, this was a decline from 31 per cent in 1991 to 27 per cent in 1992 and as a percentage of GDP such transfers declined from 6.9 per cent to 5.7 per cent between the two years.

Capital expenditure and net lending in 1992 totalled Rs. 28,901 million. This consisted of Rs. 34,027 million on account of public investment and a reduction in government liabilities totalling Rs. 5,126 million due to receipt of proceeds from privatisation and loan repayments by public corporations. In terms of the public sector investment programme, capital expenditure directly incurred by ministries and departments for the construction and development of fixed assets totalled Rs. 15,829 million in comparison to Rs. 14,072 million in the previous year. Moreover, capital transfers to statutory boards and public corporations engaged in the implementation of projects under the public investment programme amounted to Rs. 11,440 million in comparison to Rs. 9,983 million in 1991. Meanwhile, capital expenditure incurred by public corporations from funds mobilised by way of government on-lending amounted to Rs. 6,007 million - considerably lower than the magnitude of Rs. 9,000 million anticipated in the budget estimates.

The revenue and expenditure flows discussed above, resulted in a budget deficit totalling Rs. 31,509 million in 1992. This was a sharp drop of Rs. 11,840 million over the deficit in 1991. As a ratio of GDP, the deficit declined from 11.6 per cent in 1991 to 7.4 per cent in 1992. In financing the deficit, a sum of Rs. 14,569 million was mobilised through foreign borrowings. However, after allowing for loan repayments totalling Rs. 6,585 million, the net foreign borrowings for budgetary purposes during 1992 amounted to only Rs. 7,984 million - almost half the quantum available in the previous year. Meanwhile, gross borrowings for budgetary purposes from domestic sources by way of Rupee loans, Treasury bills and administrative arrangements amounted to Rs. 35,690 million. However, after allowing for amortisation payments totalling Rs. 18,123 million, the net borrowings from domestic sources were Rs. 17,567 million in 1992, as compared with Rs. 17,015 million utilised in the previous year. In the context of a reduced budget deficit and the considerable volume of resources available from both foreign and domestic sources for financing it, net borrowings from the banking system for budgetary purposes was negative to the tune of Rs. 2,321 million in 1992.

The government debt at the end of 1992 at Rs. 404,870 million was an increase of 10 per cent over that of 1991. Domestic debt at Rs. 170,020 million constituted 42 per cent of the total debt, while foreign borrowings totalling Rs. 234,850 million represented the balance 58 per cent. In the case of domestic debt, reflecting the heavy reliance on Treasury bills for raising funds during the year, the short-term debt at Rs. 97,924 million recorded a growth of 16 per cent. The debt outstanding on account of Treasury bills at Rs. 87,096 million at the end of 1992 reflected an increase of Rs. 14,128 million. Meanwhile, the outstanding foreign debt at Rs. 234,850 million marked an increase of Rs. 20,274 million or 9 per cent over the previous year. However, the major part of the increase in foreign debt amounting to Rs. 12,289 million was due to exchange rate variations during the year. Accordingly, the increase in foreign debt attributed to budgetary operations in 1992 was only Rs. 7,984 million.

The total debt service payments of the government consisting of amortisation and interest payments totalling Rs. 50,027 million in 1992 was an increase of 26 per cent over the previous year. Accordingly, the service payments as a ratio of GDP rose to 11.8 per cent in 1992 from 10.6 per cent in 1991. Amortisation payments at Rs. 24,708 million constituted 49 per cent of the total debt service commitments, while interest payments at Rs. 25,319 million comprised the balance. Of the amortisation payments, commitments on account of domestic debt totalled Rs. 18,123 million - an increase of 40 per cent over 1991. Meanwhile, amortisation payments on account of foreign debt at Rs. 6,585 million was an increase of 35 per cent. Reflecting higher rates of interest and an increased volume of short-term debt, interest payments on short-term debt at Rs. 11,355 million marked an increase of 9 per cent. Interest payments on medium and long-term debt at Rs. 9,278 million showed an increase of 23 per cent. Meanwhile, interest payments on foreign debt rose by 14 per cent to Rs. 4,686 million in 1992.

A slight moderation in the rate of monetary expansion was a welcome development in the field of macro-economic management in 1992. The narrow money supply (M_1), consisting of currency and demand deposits held by the public, expanded by 7 per cent in 1992 as compared with an increase of 18 per cent in the previous year. Following the same trend, the annual increase of broad money supply (M_2), comprising M_1 plus time

TABLE 1.5

MONETARY MAGNITUDES 1987 - 1992

Rs. Million

Item	1987	1988	1989	1990	1991	1992
Change in Domestic Credit	11,457	21,302	5,454	17,543	14,362	19,121
Increase in Net Credit to Government	4,502	9,017	54	3,078	2,595	558
Increase in Credit to Government Corporations	2,627	3,421	3,075	1,774	-1,559	673
Increase in Credit to Co-operatives	-301	195	-140	418	161	264
Increase in Credit to other Private Sector	4,629	8,669	2,465	12,273	13,165	17,626
Change in Net External Banking Assets	111	-2,233	-2,326	5,474	7,099	6,453
Change in Total Assets / Liabilities	11,568	19,069	3,128	23,017	21,461	25,574
Increase in Broad Money Supply (M_2)	7,475	9,611	8,487	14,584	21,080	18,604
Increase in other Liabilities (Net)	4,093	9,458	-5,359	8,433	381	6,970
Percentage Increases in Monetary Magnitudes						
Percentage Increase in Total Domestic Credit	17.9	28.2	5.6	17.1	12.0	14.2
Percentage Increase in Total Assets and Liabilities	15.8	22.4	3.0	17.7	16.4	16.9
Government as a percentage of Total Domestic Credit Increase	39.3	42.3	1.0	17.5	18.1	2.9
Non Government as a percentage of Total Domestic Credit Increase	60.7	57.7	99.0	82.5	81.9	97.1
Percentage Increase in:						
Broad Money Supply (M_2)	14.7	16.4	12.4	19.1	23.2	16.6
Narrow Money Supply (M_1)	18.4	29.1	9.1	12.8	18.0	7.3

Source : Central Bank of Sri Lanka

and savings deposits held by the public with commercial banks, declined from 23 per cent to 17 per cent over the two years. The deceleration in the rate of monetary expansion was despite a significant rise in the external assets (net) of the banking system which continued to fuel liquidity in the economy. Accordingly, the more favourable development in the monetary scene in 1992 was the outcome of aggressive open market operations by the Central Bank.

Although the trend of monetary developments was favourable, the levels of growth were still comparatively high from the viewpoint of maintaining macro-economic stability. The major factors contributing to high monetary growth in 1992 were the growth in external banking assets and the expansion in credit to private sector. In all, external assets (net) of the banking system rose by 37 per cent during the year, while the rate of growth of credit to private sector stood at 23 per cent. In comparison, bank credit to government exerted only a moderate expansionary impact on the money supply in 1992.

The expansion in the monetary base (or reserve money) at Rs. 4,802 million or 12 per cent in 1992 was relatively modest. The comparable increase in 1991 was Rs. 8,476 million or 27 per cent. From the source side, the expansion in monetary base was entirely caused by a considerable build-up of net foreign assets (NFA) of the Central Bank amounting to Rs. 7,563 million. In contrast, the net domestic assets (NDA) of the Bank decreased by Rs. 2,760 million, thereby moderating the rate of growth of the monetary base during the year. The decline in the NDA was largely due to successful open market operations by the Bank. Meanwhile, refinance credit from the Central Bank recorded an increase of Rs. 419 million in 1992. Reflecting increased pressure for credit, the money multiplier, *i.e.* the ratio between the money supply and the monetary base, rose somewhat sharply to 2.91 by December, 1992 from 2.80 an year ago.

Following the trend observed in recent years, high domestic credit growth and accumulation of external banking assets were the major contributory factors for the pressure on monetary aggregates in 1992. In all, domestic credit expanded by Rs. 19,121 million (14 per cent) in 1992, following the increases of Rs. 17,543 million (17 per cent) in 1990 and Rs. 14,362 million (12 per cent) in 1991. Meanwhile, net foreign assets (NFA) of the banking system which rose by Rs. 5,474 million (116 per cent) and Rs. 7,099 million (70 per cent) in 1990 and 1991, respectively, registered a further increase of Rs. 6,453 million (37 per cent) in 1992. The uninterrupted growth in both domestic credit and net foreign assets reflect the continued buoyancy of the economy in the context of continuous macro-economic adjustments and further liberalisation initiatives undertaken during the year.

Almost the entire credit growth in 1992 was in respect of the private sector. In all, gross credit to private sector rose by Rs. 18,563 million (20 per cent), while net credit to government (NCG) from the banking system expanded by a marginal Rs. 558 million (1.3 per cent). Within the private sector, the larger share of bank credit amounting to Rs. 17,626 million was utilised by the other private sector (private sector proper). In comparison, the growth in bank credit to public corporations was Rs. 673 million and to co-operative institutions Rs. 264 million. The continued high growth in credit to the other private sector despite the high interest rates reflect the economic prospects in that sector in the wake of policies directed at encouraging the private sector to play the dominant role in the economy in promoting investment and growth.

In contrast to a decrease of Rs. 1,559 million (10 per cent) in 1991, commercial bank credit to public corporations rose by Rs. 673 million (5 per cent) in 1992. However, the increase in bank credit to public corporations in 1992 was heavily influenced by the borrowings of the Ceylon Electricity Board (CEB) which had to place heavy reliance on bank credit due to the additional expenditure incurred on thermal power generation to overcome the shortfall in hydro-power due to the drought conditions. Altogether, commercial bank credit to the CEB rose by Rs. 2,145 million during the year. Among the other corporations which made increased recourse to bank credit in 1992 were the Janatha Estates Development Board (JEDB) and the Sri Lanka State Plantations Corporation (SLSPC) whose credit levels expanded by Rs. 849 million and Rs. 648 million, respectively. Meanwhile, the Ceylon Petroleum Corporation (CPC) and the Co-operative Wholesale Establishment (CWE) reduced their bank credit by Rs. 1,183 million and Rs. 784 million, respectively during the year.

Under the impact of continued fiscal adjustments and aggressive open market operations by the Central Bank, the use of bank credit by the government was very modest in 1992. During the year, net credit to government (NCG) rose by Rs. 558 million, as compared with an increase of Rs. 2,595 million in 1991. The expansion in NCG in 1992 was the combined outcome of an increase in credit from the Central Bank amounting to Rs. 984 million and a reduction of Rs. 426 million from commercial banks. However, credit to government from the Central Bank included a special loan of Rs. 1,201 million on account of subscription payments to the IMF consequent to the quota increase under the 9th General Review of Quotas. There was also a sharp decline in the Central Bank's holdings of cash items in process of collection on behalf of the government. When allowance is made for these items, the utilisation of bank credit by the government for budgetary purposes during 1992 was negative to the tune of Rs. 2,321 million.

For the third consecutive year, the external sector exerted a large expansionary impact on the money supply in 1992. Following the increase of Rs. 7,099 million (70 per cent) in 1991, the net foreign assets (NFA) of the banking system rose by Rs. 6,453 million (37 per cent) in 1992. Unlike in the previous year, when the growth in NFA was wholly confined to the second half of the year, in 1992 the expansion in foreign assets was more evenly distributed through the year. Despite a continuing deficit in the current account of the balance of payments, the external assets of the banking system rose during the year due to the availability of resources in the capital account in excess of the current account deficit.

The liquidity in the commercial banking system remained at a satisfactory level in 1992. The total liquid assets of commercial banks which rose by Rs. 8,563 million in 1991 recorded a further increase of Rs. 4,749 million in 1992. Meanwhile, demand deposits rose moderately by Rs. 1,781 million during the year. Accordingly, the ratio of liquid assets to demand deposits increased further from 160 per cent in 1991 to 167 per cent in 1992, suggestive of an improved liquidity position in commercial banks. However, the ratio of liquid assets to total deposits dropped further from 43 per cent in 1991 to 40 per cent in 1992 reflecting the enhanced deposit base of the commercial banking system.

Against the background of enhanced liquidity, the activities in the inter-bank call money market showed a contraction during 1992, the turnover declining by Rs. 17,695 million (8 per cent) in contrast to an increase of Rs. 9,549 million (4 per cent) in the previous year. However, with the extension of the reserve requirement to cover foreign currency deposits of commercial banks in September, 1992 the banking system once again became liquidity constrained, thus exerting pressure on call money rates. Accordingly, the call money rates which narrowed from a range of 13-27 per cent per annum at end-1991 to 15-19 per cent in August, 1992, widened again to 10-32 per cent per annum by the end of the year.

The expansion of the bank branch network in the country received further impetus in 1992. Following the increases of 49 and 50 branches in 1990 and 1991, respectively, a further 83 new bank branches were opened during 1992 thereby causing the banking density in the country to rise considerably. The latter included 48 branches established by commercial banks, 32 RRDB branches and 3 branches by the National Savings Bank. Following the pattern in the recent past, once again the domestic private commercial banks played the dominant role in expanding the bank branch network in the country. Altogether, 31 new bank branches were opened by domestic private commercial banks during 1992. These consisted of 15 branches by the Seylan Bank Ltd., 7 by Commercial Bank of Ceylon Ltd., 6 by Hatton National Bank Ltd., and 3 by the Sampath Bank Ltd. Meanwhile, the Bank of Ceylon opened 5 new bank branches while the People's Bank also opened 5 branches. A significant feature of bank branch expansion in 1992 was the expansion of the branch network of foreign commercial banks. In all, these banks opened 7 new branches consisting of 3 by the Hongkong & Shanghai Banking Corporation Ltd., 2 by the Standard Chartered Bank and 1 each by the ANZ Grindlays Bank plc and Public Bank Berhad. Thus, the developments in the bank branch network in 1992 were conducive for further reducing the dominant position of state sector banks in the commercial banking system of the country. It was also reflective of the continuing thrust towards generating greater competition in the banking sector and the enhanced confidence of the international banking community in Sri Lanka's economic prospects.

The total assets/liabilities of the Central Bank registered a moderate rise of Rs. 5,419 million (6 per cent) in 1992. The comparable increases in 1990 and 1991 were Rs. 14,692 million (23 per cent) and Rs. 18,373 million (24 per cent), respectively. On the assets side, the increase was wholly reflected in the external assets of the Bank which rose by Rs. 11,433 million (40 per cent) during the year. This was the third successive year when the external assets (gross) of the Central Bank showed a substantial rise - the increases in 1990 and 1991 being Rs. 6,436 million (65 per cent) and Rs. 12,557 million (77 per cent), respectively. Meanwhile, the domestic assets of the Central Bank declined by Rs. 6,014 million (9 per cent) during the year in contrast to increases of Rs. 8,256 million (16 per cent) in 1990 and Rs. 5,816 million (10 per cent) in 1991. The major underlying factors for the decrease in domestic assets were the reductions in the holdings of government and government guaranteed securities by Rs. 8,062 million and in other assets and accounts by Rs. 1,056 million. The decrease in the holdings of government and government guaranteed securities was purely on account of open market operations by the Bank. Although loans and advances to government increased by Rs. 2,685 million, a considerable portion of this was on account of a special loan to meet the obligations arising from the quota increase in the IMF effected during the year. Meanwhile, loans and advances to commercial banks and other financial institutions increased by Rs. 419 million owing to continued refinance credit granted to finance companies during the year. In contrast, these loans declined by Rs. 1,986 million (27 per cent) in 1991.

On the liabilities side, the domestic liabilities of the Central Bank rose by Rs. 1,548 million while foreign liabilities increased by Rs. 3,871 million in 1992. The expansion in domestic liabilities was largely reflected in currency in circulation which rose by Rs. 2,974 million. The domestic liabilities of the Bank were also augmented by the rise in deposit liabilities following the inclusion of foreign currency deposits for the purpose of maintenance of reserves in September, 1992. Meanwhile, government deposit liabilities which recorded a somewhat sharp increase in the previous year decreased by Rs. 6,362 million (11 per cent) in 1992. The growth in external liabilities was fully reflected in a further build-up of deposits of international organisations amounting to Rs. 3,871 million.

The general level of short term interest rates tended to remain high for the second consecutive year in 1992. In view of continued efforts on the part of the Central Bank to siphon-off excess liquidity arising from the accumulation of external assets through open market operations, interest rates in the Treasury bills market moved upwards, particularly during the first 3 quarters of the year. Accordingly, the weighted average yield on Treasury bills with 3-months maturity increased from 16.33 per cent per annum at the end of 1991 to 18.33 per cent per annum in October, 1992 before declining to 17.70 per cent at the end of the year. Similarly, the yield on Treasury bills with maturity periods of 6-months and 12-months also increased from a range of 16.38 to 17.43 per cent per annum at the end of 1991 to 18.05 to 19.00 per cent per annum at the end of 1992. Reflecting these developments, the discount rates in the secondary market for Treasury bills also recorded increases during the year. Meanwhile, interest rates in the call money market continued to fluctuate in line with changes in short-term liquidity conditions in the market. Thus, call money rates which varied within a range of 13 - 27 per cent per annum at the end of 1991 recorded a wider range of 10 - 32 per cent per annum at the end of 1992. In line with the trends in the Treasury bills markets, interest rates on fixed deposits with short term maturities tended to remain high. The maximum interest rates on 3-months and 6-months deposits in commercial banks stood at 18.5 per cent, as compared with 18.5 per cent and 19 per cent, respectively, at the end of 1991. The maximum rate on 12-months deposits remained unchanged at 20 per cent. At the same time, maximum rates on deposits with maturities of 12 - 24 months also tended to remain high in a range of 20 - 21 per cent per annum. Meanwhile, the National Savings Bank (NSB) maintained its deposit rates at the previous year's levels. Thus, the rates offered on 12 and 24 months fixed deposits remained unchanged at 17 and 18.5 per cent, respectively, while the rate offered on savings deposits also remained unchanged at 14 per cent. With a view to reducing distortions in the interest rate structure, the Central Bank refinance rates applicable to short term and MLCF facilities were also revised upwards in line with the movements in market rates to reflect the trends in the overall interest rates structure in the economy.

Under the impact of high short-term interest rates, the medium and long-term rates also tended to remain high during the year. Thus, the Average Weighted Prime Lending Rate (AWPR) of the commercial banks increased from 19.6 per cent per annum at the end of 1991 to 20.2 per cent per annum at the end of 1992. Meanwhile long-term rates continued to remain high with the government securities of 2 years and 4 years maturity carrying interest rates of 17 and 15 per cent per annum, respectively. As in the previous year, the lending rates of development financial institutions also tended to remain high during 1992. Thus, the lending rates of the DFCC were in a range of 17.5 to 23.5 per cent per annum, while those of the NDB were in a range of 19 - 21 per cent per annum. The

State Mortgage & Investment Bank (SMIB) which unified its rates in December 1991 at 20.5 per cent per annum continued to charge the same rate during 1992.

In the context of continued high growth in monetary aggregates and accompanying inflationary pressures, in 1992 the Central Bank was obliged to continue with the tight monetary policy stance pursued since 1989 with further modifications and rationalisations to improve its effectiveness. However, unlike in the past, the Bank relied entirely on market based indirect policy instruments in monetary management. Accordingly, the major thrust of policy in 1992 was on open market operations (OMO) and the statutory reserve ratio (SRR). Meanwhile, direct credit control measures that were in place since 1989 were eliminated. Accordingly, the 100 per cent deposit margin on Letters of Credit in respect of selected non-essential imports was withdrawn in August 1992, while the ceiling on commercial bank credit to selected non-priority sectors was also removed.

As mentioned previously, in 1992 the major thrust of monetary policy was on open market operations. The Bank conducted its open market operations on Treasury bills to siphon-off excess liquidity, taking into account the government's cash requirements, level of refinance credit, changes in foreign assets and developments in other components of the monetary base. The Bank used both primary and secondary markets for the disposal of Treasury bills to the public in order to maintain its reserve money targets. This resulted in the yields on Treasury bills moving in accordance with the liquidity conditions in the economy.

During the year, several steps were taken to strengthen the market for Treasury bills. First, primary dealers consisting of commercial banks and selected financial institutions were appointed in June, 1992 to broaden the market outlets for Treasury bills and increase the activities in the secondary market. Second, with a view to providing a broader spectrum of maturities, Treasury bills with longer maturities were issued during the year. Third, in order to provide necessary information to the public on the primary market, the amount maturing and the amount available to the public at each auction were made known to the public through advertisements. Fourth, the gap between discount and re-discount rates was further narrowed from 2 percentage points to one percentage point, with a view to improving the attractiveness of secondary Treasury bills as a form of investment.

The changes spelt out above resulted in a significant increase in the non-bank sector's participation in the Treasury bills markets. Accordingly, the Treasury bill holdings of the non-bank sector rose by Rs. 18,496 million to Rs. 43,618 million during the year, raising the share of Treasury bills held by the non-bank sector from 38 per cent of the total outstanding at the end of 1991 to 57 per cent at the end of 1992. Correspondingly, despite fresh issues of Treasury bills amounting to Rs. 14,128 million, the holdings of the Central Bank dropped from Rs. 29,854 million at the end of 1991 to Rs. 21,795 million at the end of 1992 - a decline of Rs. 8,059 million or 27 per cent. In terms of the percentage share, the Central Bank's holdings declined from 46 per cent at the end of 1991 to 29 per cent at the end of 1992.

The other major instrument of monetary policy, namely, the statutory reserve ratio (SRR) was further rationalised and strengthened during the year. Thus, the vault cash holdings of commercial banks over and above 2 per cent (but not exceeding 4 per cent) of total deposit liabilities were allowed to be counted for the purposes of required reserves with effect from January, 1992. This concession was granted with a view to reducing the burden on banks having to carry excessive till-cash on account of their branch networks and special public responsibilities. However, in order to neutralise the expansionary impact of this concession on credit expansion, the reserve ratio was revised upwards by 1 percentage point to 14 per cent. Meanwhile, it was observed that the exclusion of foreign currency deposit liabilities of commercial banks from the reserve requirement tended to weaken the effectiveness of the SRR as a monetary policy instrument, in a context when such deposits had been rising steadily in recent years. Accordingly, with effect from September 4, 1992 the reserve requirement was extended to cover all deposit liabilities of commercial banks including foreign currency deposits. At the same time, the SRR was reduced from 14 per cent to 13 per cent to soften the impact on commercial banks of the enlarged reserve base.

The Central Bank also endeavoured to further rationalise and curtail refinance credit during 1992, which had been a major source of liquidity creation in recent years. These included sharp cutbacks on short-term refinance, suspension of MLCF refinance and progressive increases in interest rates on most refinance facilities in order to bring them closer to market rates, thereby reducing the distortions in the interest rate structure of the country. However, as the Central Bank was obliged to accommodate requests for refinance from finance companies in distress, the outstanding level of overall refinance recorded a moderate increase of Rs. 419 million (8 per cent) during the year. The increase in refinance credit in 1992 on account of finance companies was Rs. 946 million.

The year 1992 witnessed interest rate policy coming under intense pressure and becoming a controversial policy instrument in economic management, both in the international arena as well as in the domestic scene. In the international arena, some countries continued to follow cheap money policies with a view to putting back their moribund economies on the recovery path in the face of lingering recession. In some others, sharp cut-backs on interest rates were observed in an attempt to push-start economic recovery following severe down-turns in economic activity involving heavy costs in terms of business failures and unemployment. This was against the background of relentless downward pressure on exchange rates, and, therefore, was suggestive of an abandonment of interest rate policy as an instrument to support domestic currency and macro-economic stability. Meanwhile, in yet others' the policy stance was exactly the opposite when the authorities continued to follow high interest rate policies as a counter-inflationary measure, no doubt with serious adverse implications both for growth and employment and much against domestic and international opinion. Thus, the signals emanating from the international scene on the interest rate front during 1992 were conflicting and devoid of any clear direction. In some instances, the directional changes were very confusing and almost questioned the conventional wisdom on the use of interest rate policy as an instrument in economic management.

On the domestic scene, the authorities were obliged to continue with a high interest rate policy against the background of continuing high rates of monetary expansion and sustained high inflationary pressures. This resulted in the entire interest rate structure remaining high and raising concerns about the wisdom of continuing with a high interest rate policy for a prolonged period. Some expressed the view that the high interest rate policy pursued to control inflation was detrimental to investment, growth and employment thereby aggravating the very problems that it sought to resolve. Some argued that domestic interest rates were too high in relation to rates prevailing in other countries, thus eroding the competitiveness of Sri Lankan exports in international markets. Yet others were of the view that there were signs of the inflation rate easing-off and the policy of continuing with high interest rates was no longer warranted. In this background, a word of explanation of the rationale of current interest rate policy is perhaps appropriate.

In general, interest rate policy plays an important role as a demand management technique to achieve both internal and external balance and to ensure efficient allocation of resources in an economy. The level and structure of interest rates affect the ability of a central bank to maintain control over reserve money growth and, therefore, the rate of monetary expansion and the balance of payments developments. Therefore, it is of paramount importance that interest rates are maintained at appropriate levels given the other macro-economic conditions in an economy.

It is generally accepted that a reasonable degree of monetary stability is a pre-requisite for attaining durable and sustained economic expansion. In other words, the general perception is that monetary policy can best contribute to economic development by achieving and maintaining price stability. In Sri Lanka, the annual rate of monetary expansion had been remaining at levels exceeding 20 per cent for the most part of 1992. Meanwhile, the inflation rate too tended to remain high almost closer to the levels prevailing in 1991. The major reason for the excessive growth in money supply had been a rapid build-up of external assets. Altogether, the country's net external banking assets rose by Rs. 6,453 million in 1992 far exceeding the increase anticipated at the beginning of the year. In order to siphon-off excess liquidity thus created by the expansion in external assets, the Central Bank was obliged to follow a tight monetary policy, a major plank of which being the high interest rate policy. The sterilization of excess liquidity necessitated that interest rates on Treasury bills remained high to facilitate the divesting of Treasury bills from the Central Bank's portfolio. This resulted in the entire interest rate structure remaining high. Thus, it was in order to reduce the rate of growth of money supply and to promote price stability that the interest rates had to remain high during 1992. Failure to maintain interest rates at high levels would have meant less success at open-market operations and, therefore, failure to sterilize excess liquidity being injected into the economy through the expansion in external assets with accompanying implications on monetary stability and the price level.

Furthermore, the government still continues to borrow a considerable volume of funds in the domestic market for financing the budget deficit. In the government's borrowing programme, in more recent years greater reliance had been placed on Treasury bills which carry market rates of interest as against government bonds which are historically being issued at less than market rates. During 1992, in all new Treasury bills to the value of Rs. 14,128 million were issued, which had to be marketed to non-Central Bank sources. The disposal of such a large volume of Treasury bills to non-Central Bank sources necessarily required that the yields were maintained at attractive levels. Thus, it is important that the government further reduces its budget deficit to a level that would permit it to borrow directly from the market in competition with the private sector, without crowding out the latter, before the country could move onto a more appropriate level and structure of interest rates.

Also, in more recent years, the Central Bank had been moving away from selective credit controls in the management of monetary policy, such as restrictions on credit to non-priority sectors and deposit margins against Letters of Credit. Accordingly, the Bank had been relying mainly on indirect controls of monetary management such as the statutory reserve ratio and open market operations. This resulted in a heavy burden falling on interest rates as a monetary management tool.

There is yet another compelling reason as to why interest rates tended to remain high during 1992. It may be recalled that although there were signs of easing inflationary pressures, the rate remained above the 9.5 per cent level, on an year-on-year basis, throughout 1992 while the annual average rate was 11.4 per cent. During periods when inflation is high, the public which undertakes savings are reluctant to invest in financial assets, because of the possibility of incurring losses on such savings, due to erosion of the value of money. During such periods, it is of paramount importance that interest rates are maintained at high levels, in order to ensure that savers receive a reasonable positive real rate of return. In such situations, if interest rates are allowed to drop to low levels, the savings momentum will be broken through a reduction in the public's demand for domestic financial assets and the country will be faced with serious investment and balance of payments problems. The reduction in the demand for financial assets would force the financial institutions to curtail their lending to productive sectors of the economy with implications on investment and growth.

The primary objective of economic policy in a developing country like Sri Lanka is the promotion of growth and economic development. Achievement of the growth objective requires that the country allocates a reasonable portion of its resources to investment. Accordingly, high priority should be accorded to policies aimed at increasing the volume of domestic savings. As stated above, one such policy should be an active interest rate policy so as to provide a reasonable positive real rate of return to savers. Failure to generate adequate savings to meet the increased investment demand will result in either the financial system resorting to various rationing schemes to allocate available credit or excessive dependance on foreign resources, with all attendant adverse consequences.

A drop in the demand for domestic financial assets would also involve important implications for the balance of payments. In a small and relatively open economy like Sri Lanka, as the demand for domestic financial assets fall, there will be increased demand for foreign assets, leading to capital outflows. Large capital outflows, which would compound the current account problems arising from reduced domestic savings, would force the country either to increase the amount of foreign borrowings or to draw on international reserves, with continuing pressure on the exchange rate. Although there are restrictions on capital movements, capital outflows would continue through a variety of channels. On the contrary, what is required in the country at the present moment is a net capital inflow to supplement domestic savings for achieving development objectives.

Moreover, the level of interest rates can also have a bearing on the quantum of fixed investment out of a given volume of savings. When interest rates are low, relative to the prevailing rate of inflation, firms will find it profitable to borrow, not only for investment purposes but also as inflationary hedges, such as inventories, imported goods, real estate and foreign currency deposits. These additional demands for funds tend to "crowd out" financing for fixed investments.

A policy of maintaining interest rates that are low relative to the rates of inflation tends to lower the productivity of investment as well. First, in the face of limited amounts of financial savings forthcoming, administrative arrangements such as selective credit policies will have to be put in place to ration scarce financial resources, with accompanying inefficiencies in resource utilisation. Such credit rationing tends to reduce the necessity for careful evaluation of projects by enterprises and the economical use of resources in the implementation of these projects. Second, even in the absence of credit rationing, the resource allocation efficiency can get distorted as the well established firms would tend to be favoured over smaller or newer borrowers, without regard to the rates of return on the respective investments. Third, it would result in a bias in investment, in favour of capital intensive techniques, which will lead to high unemployment and social unrest.

It may also be pointed out that with negative or low real interest rates, the distribution of income and wealth can be in favour of the upper income groups in the country. Low income households and producers have little opportunity to invest their savings other than in financial assets, having at the same time limited access to credit from financial institutions. On the other hand, high income households and owners of large production units have a wider scope for borrowing funds as well as for placing their savings in a variety of investments, which act as inflation hedges.

The foregoing analysis would show that there was little room to follow a cheap money policy in Sri Lanka in 1992 in the context of macro-economic challenges facing the country, more particularly the continuing high rates of monetary expansion and the accompanying inflationary pressures. A policy stance other than a high interest rate policy would have compounded these problems, bringing in its wake financial repression and pressure on the balance of payments and the exchange rate. This is not to argue that for a developing country like Sri Lanka a high interest rate policy is imperative and is a panacea for all economic ills. What is stressed, however, is that given certain macro-economic conditions facing the country, a high interest rate policy is one which is likely to involve least economic damage.