ECONOMIC PERFORMANCE, PROBLEMS AND POLICIES IN 1994

A sustained favourable growth performance following strong growth in 1993, an enhanced level of private investment and a significant deceleration in the rate of increase in consumer prices were among the highlights of Sri Lanka's economic performance in 1994. However, a high budget deficit, a large external current account deficit and persistently high monetary growth which resulted by and large from policy slippages in the backdrop of two national elections remained major areas of concern in macro economic management in 1994. However, a significant development following the elections was the policy statement of the new Government with its commitment to pursue the process of economic liberalisation and to strengthen the market friendly economic environment which would guarantee the continuity of economic policies pursued in recent years.

OVERALL PERFORMANCE

Sri Lanka's Gross Domestic Product (GDP), in real terms, increased by 5.6 per cent in 1994 following the growth of 6.9 per cent recorded in the previous year. Gross National Product (GNP), which includes net factor income from abroad, rose by 5.3 per cent. Although this reflected a slight decline in the high growth momentum generated in 1993 under the impact of recent liberalization initiatives and structural reforms which brought the private sector to the forefront of economic development, the economic performance during 1994 displayed the continued resilience in the

TABLE 1.1

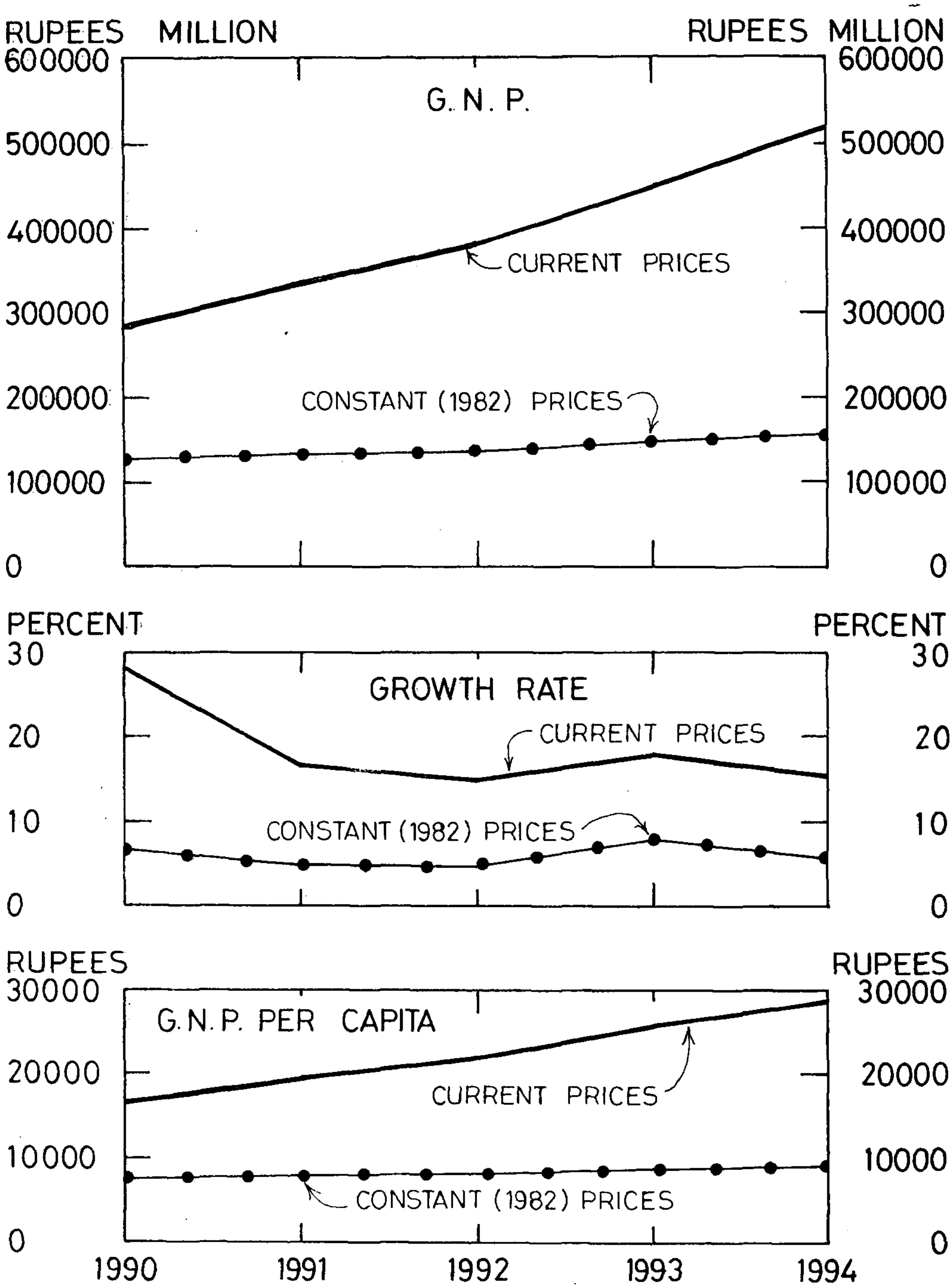
National Income Statistics 1992 - 1994

Item	Amount (Rs. Million)			Growth Rate	
	1992*	1993*	1994*	1993*	1994*
1. GDP at Current Factor Cost Prices	386,999	453,092	523,300	17.1	15.5
2. GDP at Constant (1982) Factor Cost Prices	140,990	150,783	159,269	6.9	5.6
3. GNP at Current Factor Cost Prices	379,179	447,113	515,272	17.9	15.2
4. GNP at Constant (1982) Factor Cost Prices	138,074	148,744	156,662	7.7	5.3
5. GNP at Current Market Prices	424,313	499,622	575,810	17.7	15.2
6. Mid Year Population ('000)	17,405	17,619	17,865	1.2	1.4
7. GNP Per Capita					
i. At Current Factor Cost Prices (Rs.)	21,786	25,377	28,843	16.5	13.7
ii. At Constant Factor Cost Prices (Rs.)	7,933	8,442	8,769	6.4	3.9
iii. At Current Market Prices (Rs.)	24,379	28,357	32,231	16.3	13.7

* Provisional

Source: Central Bank of Sri Lanka

GROSS NATIONAL PRODUCT



Central Bank of Sri Lanka.

economy. On the external front, the terms of trade declined by 4.7 per cent in contrast to the improvement of 2.0 per cent in 1993. On the domestic front, Sri Lanka went through three elections in 1994 which led to a change of government. Policy slippages in the midst of national elections and disruptions in industrial activities during the latter part of the year undermined business confidence. These developments had implications on the performance of several sectors of the economy.

In spite of a sustained growth in tea, coconut and paddy, the overall Agricultural sector recorded only a 3.3 per cent growth in comparison to 4.9 per cent in the previous year. The Manufacturing sector's growth decelerated from 10.5 per cent to 9.1 per cent owing to a reduced pace of growth in the factory industry sub-sector which resulted from the uncertainty in the availability of garment quotas in certain categories and the disruptions in industrial activity during the latter part of the year. Meanwhile, under the impact of a slower expansion in agriculture and industrial activity, the services sector growth moderated to 5.2 per cent in 1994 from 6.3 per cent in 1993.

A deterioration in the macro economic environment, and the policy slippages on the eve of national elections threatened to thwart the high growth momentum generated in 1993. The relaxation of the tight fiscal policy stance resulted in large imbalances in the government fiscal operations exerting considerable demand pressure in the economy. The current account of the government budget, which generated a large deficit of 2.9 per cent of GDP, in comparison to a deficit of 0.8 per cent in the previous year, depressed the country's saving effort. Influenced by high current expenditure, the overall budget deficit increased to 10 per cent of GDP from 8.4 per cent in the previous year necessitating an enhanced level of net domestic borrowing in the order of 6.5 per cent of GDP. As a consequence of high domestic borrowings by the Government and a sustained increase in private sector credit from the banking system, monetary aggregates continued to remain under pressure resulting in an increase in money supply by 19.7 per cent.

Underscoring high demand pressure in the economy, the savings/GDP ratio declined from 16 per cent in 1993 to 15.2 per cent in 1994 while the investment/GDP ratio increased from 25.6 per cent to 27 per cent widening the resource gap between savings and investment. The decline in the savings/GDP ratio was entirely due to the deterioration in government savings. In fact, the decline in government savings (which was manifested in a rise from a negative level of 0.8 per cent of GDP in 1993 to a higher negative level 2.9 per cent of GDP in 1994) indicated that private savings continued to rise during the year. Parallel with these developments in aggregate savings and investment was the considerable deterioration in the current account of the balance of payments with the deficit rising from 3.8 per cent of GDP in 1993 to 6.5 per cent of GDP in 1994. This, together with a slowing down of capital inflows, reduced the overall surplus in the balance of payments from SDR 375 million in 1993 to SDR 173 million in 1994.

The high demand pressure on domestic prices was clearly visible in the Colombo Consumers' Price Index (CCPI) with the annual average inflation remaining at 12 per cent during the first five months of the year. In subsequent months, the Index was heavily influenced by various discretionary measures such as ad-hoc tariff reductions, import duty waivers, and administrative price reductions announced by the Government with a view to reducing the cost of living. Improved supply conditions towards the end of the year were also conducive to moderating price pressure in the economy. Thus, in spite of unabated high demand pressure in the economy, the annual inflation, as measured by the Colombo Consumers' Price Index, averaged 8 per cent for the year. However, the sustained high monetary expansion continued to underscore considerable inflationary pressure in the economy during 1994. Unless this demand pressure is reduced through a durable reduction in the budget deficit, and the underlying structural constraints in the economy, which are discussed subsequently, are eliminated, it will be difficult to sustain high economic growth with price stability over the medium term.

National Income and Expenditure

Gross National Product (GNP) at current factor cost prices, estimated at Rs.515 billion in 1994, showed an increase of 15.2 per cent over the previous year. Meanwhile, GNP at current market prices, which is equivalent to GNP at current factor cost prices adjusted for the effect of indirect taxes less subsidies, also increased by 15.2 per cent from Rs.500 billion in 1993 to Rs.576 billion in 1994. The mid-year population of Sri Lanka in 1994 has been estimated at 17.87 million reflecting a population growth of 1.4 per cent over 1993. Correspondingly, per capita GNP at current market prices increased by 13.7 per cent from Rs.28,357 (US$ 588) in 1993 to Rs.32,231 (US$ 652) in 1994.

Gross Domestic Expenditure (GDE) at current market prices was estimated at Rs.648 billion indicating a 18.3 per cent increase over 1993. Consumption expenditure at Rs.491 billion registered an increase of 17.0 per cent in 1994. Private consumption expenditure at Rs.435 billion recorded a growth of 16.4 per cent in comparison to an increase of 16.6 per cent in the previous year. Continuing the pattern observed in 1993, private consumption expenditure on imported goods and non-factor services rose at a higher rate (24 per cent) than the expenditure on domestically produced goods (13.6 per cent). Within imported consumer goods, food and beverages and consumer durables such as motor vehicles and electrical goods recorded a significant growth. The rate of growth in government consumption expenditure accelerated from 11.8 per cent in 1993 to 22.5 per cent in 1994 mainly due to a sharp increase in government current expenditure on the purchase of goods and services by 22 per cent during the year.

TABLE 1.2
Composition and Growth Rate of GNP 1992 – 1994 at Constant (1982) Factor Cost Prices

Item	Amount (Rs. Million)			Growth Rate		
	1992*	1993*	1994*	1992*	1993*	1994*
1. Agriculture, Forestry & Fishing	30,090	31,554	32,593	-1.6	4.9	3.3
of which						
1.1 Tea	2,303	2,985	3,116	-25.7	29.6	4.4
1.2 Rubber	669	681	688	2.1	1.8	1.0
1.3 Coconut	2,971	2,799	3,376	5.1	-5.8	20.6
1.4 Paddy	5,882	6,447	6,750	-2.0	9.6	4.7
1.5 Other (other Agriculture, Forestry & Fishing)	18,265	18,642	18,663	1.6	2.1	0.1
2. Mining & Quarrying	3,300	3,693	3,915	-6.0	11.9	6.0
3. Manufacturing	26,059	28,806	31,418	8.8	10.5	9.1
3.1 Processing of Tea, Rubber & Coconut Kernal Products	2,912	3,157	3,567	-12.6	8.4	13.0
3.2 Other	23,147	25,649	27,851	12.3	10.8	8.6
4. Construction	9,765	10,400	11,024	8.1	6.5	6.0
5. Services	71,776	76,330	80,319	5.3	6.3	5.2
6. G.D.P.	140,990	150,783	159,269	4.3	6.9	5.6
7. Net Factor Income from Abroad	-2,916	-2,039	-2,607	–	–	–
8. G.N.P.	138,074	148,744	156,662	4.4	7.7	5.3

* Provisional

Source: Central Bank of Sri Lanka

Gross Domestic Fixed Capital Formation (GDFCF) estimated at Rs.154 billion showed an increase of 22.4 per cent reflecting a significant build up of the capital stock in 1994. Accordingly, the investment/GDP ratio increased from 25.6 per cent in 1993 to 27 per cent in 1994. Following the trend in recent years, a larger contribution to capital formation continued to come from the private sector. Private investment was mainly in plant and machinery, transport equipment and construction of residential as well as non-residential buildings. Meanwhile, public investment continued to be concentrated in the development of infrastructure such as port services, communication, roads and the supply of pipe borne-water. Public investment in relation to GDP declined from 8 per cent in 1993 to 7 per cent in 1994.

Domestic savings were estimated to have increased by 9.5 per cent from Rs.80 billion in 1993 to Rs.88 billion in 1994, but the savings/GDP ratio, which improved from 15 per cent to 16 per cent in 1993, dropped to 15.2 per cent in 1994 largely due to the weakening of the Government's savings effort. Government savings declined from a negative level of 0.8 per cent of GDP to 2.9 per cent of GDP. This in fact suggests that the private savings/GDP ratio increased from 16.8 per cent in 1993 to 17.9 per cent in 1994. Meanwhile, under the impact of lower aggregate domestic savings, national savings, *i.e.* domestic savings adjusted for net private transfers and net factor income from abroad, in relation to GDP declined from 20.3 per cent in 1993 to 19.1 per cent in 1994. Reflecting a high aggregate demand in the economy, the investment-savings gap widened from 5.3 per cent of GDP in 1993 to 7.9 per cent of GDP in 1994.

Trends in Gross Domestic Product (GDP)

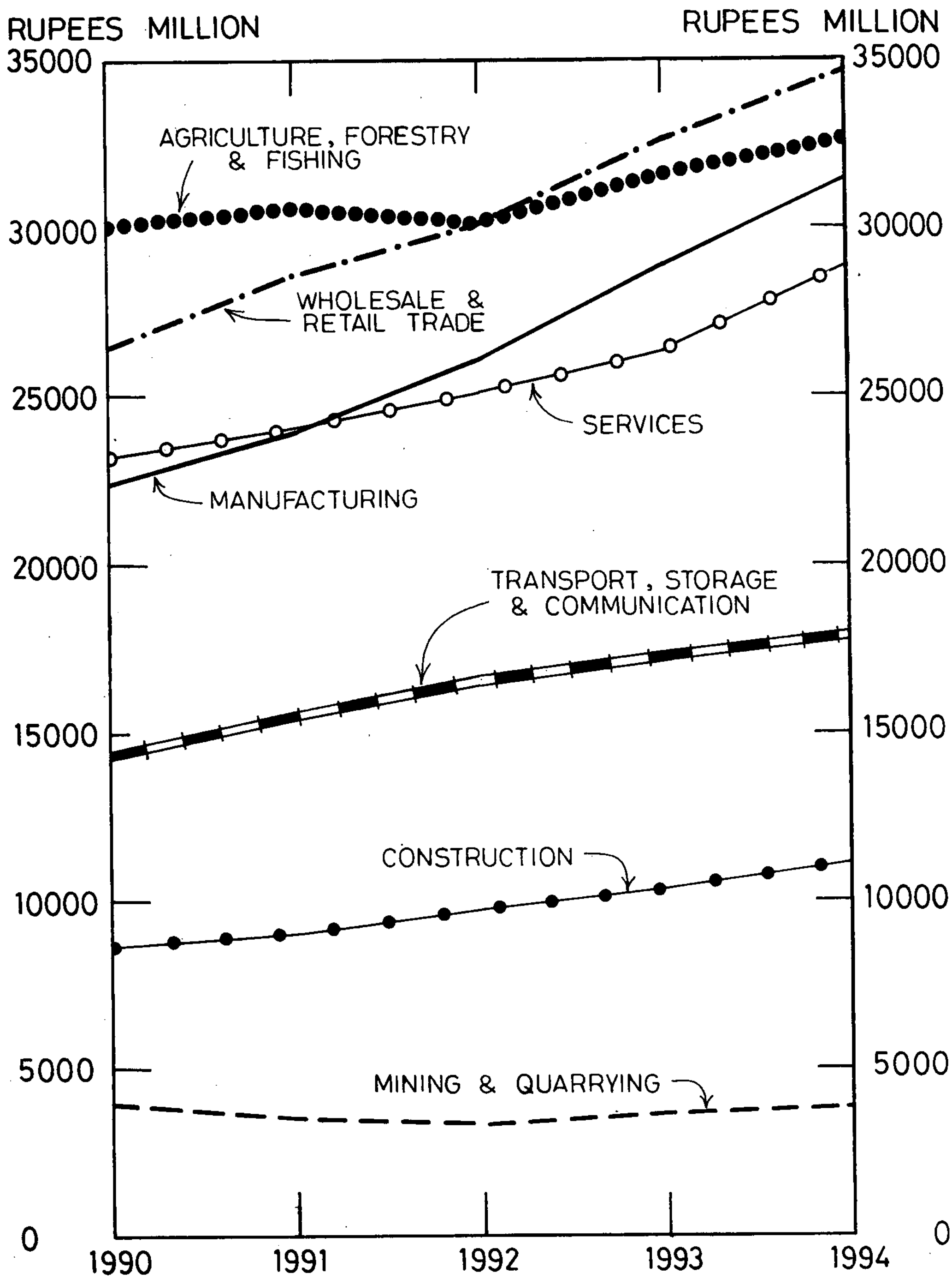
Gross Domestic Product, in real terms, increased by 5.6 per cent in 1994, in comparison to a high rate of growth of 6.9 per cent in the previous year. All sectors of the economy continued their growth momentum in 1994, but at a slower pace in the context of unfavourable developments in the macro economic environment and policy slippages in the midst of national elections. The Services sector (including Construction), maintained its predominant position in the national economy and continued to be the major source of growth, accounting for 54.3 per cent of GDP growth in 1994. The Industrial sector, which has provided considerable growth stimulus in recent years and recorded a growth of 9.1 per cent in 1994, contributed to 30.8 per cent of GDP growth, while the share of Agriculture (including Mining and Quarrying) in GDP growth was 14.9 per cent in 1994.

Primary Sector

The agriculture sector grew by 3.3 per cent in 1994, following its strong recovery in 1993 with a growth of 4.9 per cent. In spite of a decline of about 0.1 per cent in the other agriculture sub-sector, which accounts for about 50 per cent of total agriculture, the sustained increase in the production of tea, paddy and coconut contributed to the overall increase in output in the Agricultural sector in 1994. The continued favourable weather conditions were conducive to sustaining a high level of production particularly in tea and paddy. In plantation agriculture, the production of tea, rubber and coconut recorded growth rates of 4.8 per cent, 1.0 per cent and 20.6 per cent, respectively, in 1994. The substantial growth in the output of coconut was due to the lagged effect of favourable weather conditions in 1993. Meanwhile, paddy production increased by 4.7 per cent. The significant production gains in these major crops were somewhat offset by the weaker performance in the other agriculture sub-sector, whose aggregate output declined by 0.1 per cent. Within the other agriculture sub sector, an increase in output was recorded in subsidiary food crops, sugar cane, animal husbandry and dairy products, but the output of minor export crops, vegetables and fruits suffered a setback. The growth rate in the fisheries sub-sector declined to 1.4 per cent in 1994 from 7.1 per cent in 1993, while the forestry sub-sector registered a marginal decline as in the

GROSS DOMESTIC PRODUCT BY INDUSTRIAL ORIGIN

AT CONSTANT (1982) FACTOR COST PRICES



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previous year, reflecting the impact of the diminishing timber resources which have resulted from the over-exploitation in recent years.

Under the impact of increased exports of gems as well as the enhanced demand for quarrying products used in the manufacturing and construction industries, the mining and quarrying sector recorded a growth of 6.0 per cent during 1994.

Manufacturing Sector

The manufacturing sector, which has emerged as a lead growth sector in recent years, recorded a slower growth of 9.1 per cent in 1994, in comparison to a growth of 10.5 per cent in the previous year. However, as in the previous year, the impetus to economic growth was generated by the industrial sector. Within Manufacturing, factory industry, the most important sub-sector in terms of contribution to value-addition and export earnings, grew by 8.8 per cent in 1994 in comparison to a growth of 11.3 per cent in the previous year. The growth in factory industry was affected by the disruptions in industrial activities, uncertainties in the availability of quotas in certain categories of garments to the USA and weakened investor confidence in the context of policy slippages during the year. The industrial categories under factory industry that recorded strong performance in 1994 were food and beverages, textiles, apparel and leather products and non-metallic mineral products. The growth in output of plantation agriculture enabled the value-added in the processing industries of tea, rubber and coconut products to increase by 13 per cent in real terms, as against 8.4 per cent in 1993. With increasing economic activity and spin-offs from the factory industries, the small industries sub-sector is estimated to have expanded by 5.7 per cent in 1994. The other-industries sub-sector grew by 6.8 per cent, compared to 6.4 per cent in 1993. The expansion in the rice milling industry was the most conspicuous factor affecting the growth in this industrial category.

Construction

The Construction sector continued to sustain a high rate of growth for the third consecutive year, with value added in the sector rising by 6.0 per cent in 1994. The sustained growth in this sector reflected mainly the expansion in private sector construction activities in housing and commercial and industrial buildings. Public sector construction in 1994 was at a comparatively lower scale when compared with the previous year.

Services Sector

With a reduced pace of growth in agricultural and industrial activity, the services sector realised a slightly lower growth of 5.2 per cent in 1994, when compared with the growth of 6.3 per cent in the previous year. Within the Services sector, the Transport, Storage and Communication sector grew by 3.1 per cent. The Wholesale and Retail Trade sector recorded an overall growth of 6.4 per cent, primarily due to the expansion in import and export trade. The high rainfall during the year contributed to an increase in the generation of hydro electricity by 7.7 per cent in 1994. This, together with an expansion in the supply of pipe-borne water, was the major contributory factor to a high rate of growth in the Electricity, Water, Gas and Sanitary services sector. The Banking, Finance and Real Estate sector grew by 9.5 per cent in 1994 compared with a growth of 10.8 per cent in 1993. With greater diversification in financial services, the banking sub-sector remained robust during the year under review. The tourism sub-sector, which suffered a setback in 1993, recovered in 1994 with tourist arrivals and foreign exchange earnings from tourism (in SDR value) recording increases of 3.9 per cent and 10.2 per cent respectively. The expansion in the tourist industry enabled the other services sector to maintain a higher growth rate of 2.5 per cent in 1994 when compared with 2.0 per cent in 1993.

Agriculture

Tea production estimated at 242 million kg in 1994 was the highest on record and was an increase of 4 per cent over the production in the previous year. Favourable weather conditions, improved management under private management companies, and the lagged effect of the increased use of fertilizer in the previous year contributed to the high level of production in 1994. The output of low grown teas, which increased by 28 per cent to 112 million kg in 1993, further rose by 5 per cent to 118 million kg in 1994. The output of high grown teas rose by 6 per cent to record 77 million kg, while medium grown teas virtually remained at the 1993 level of 47 million kg. Meanwhile, CTC (cut, tear and curl) tea production expanded by 40 per cent to 11.2 million kg in 1994. Consequently, the share of CTC teas increased to 4 per cent of the total production in 1994 from 3 per cent in 1993.

In spite of a marginal increase in the average export (f.o.b.) price to Rs.91.32 per kg in 1994 from Rs.91.16 kg in 1993, the average gross price of all teas at the Colombo Auctions declined by 5 per cent to Rs.65.12 per kg in 1994 from Rs.68.88 per kg in 1993. Meanwhile the average cost of production (COP) of tea which rose during 1992 and 1993 decreased by 3 per cent to Rs.73.83 per kg in 1994, partly due to the allocation of fewer resources for field maintenance.

Rubber production in 1994, estimated at 105 million kg, indicated a marginal growth of one per cent over the previous year. In spite of a decline in the total extent registered under rubber by 794 hectares to 191,554 hectares in 1994, the extent under tapping increased by 4 per cent to 151,600 hectares. Sheet rubber, which accounted for 42 per cent of the total output, increased by 1 per cent to 44 million kg while the output of crepe rubber rose by 4 per cent to 35 million kg. In contrast, technically specified rubber production declined by 6 per cent to 13 million kg. The average yield of rubber dropped from 714 kg per hectare in 1993 to 692 kg per hectare in 1994. The decline in the yield was due to a loss of tapping days caused by a shortage of experienced tappers.

The average export (f.o.b.) price of all grades of rubber, which picked up in 1993 following improved demand in the major rubber consuming countries, continued to move upwards and recorded an increase of 17 per cent from Rs.44.34 per kg in 1993 to Rs.51.81 per kg in 1994. The annual average price of RSS1 at the Colombo Auctions rose by 42 per cent to Rs.50.48 per kg, while the average price of RSS2 increased by 47 per cent to Rs.49.57 per kg in 1994. Meanwhile, the cost of production of rubber in the private sector including smallholdings is estimated to have increased by 8 per cent to Rs.24.90 per kg in 1994. However, in the context of higher producer prices, this sector recorded enhanced producer margins in 1994.

The domestic consumption of rubber, which has been steadily increasing since 1985 under the impact of enhanced activities of the rubber-based manufacturing sector, recorded a further increase of 3 per cent to 34 million kg in 1994, accounting for 32 per cent of the total production during the year.

Coconut production estimated at 2,610 million nuts in 1994, was the highest level of production recorded since 1986. The increase in nut production by 21 per cent in 1994 was a reflection of the lagged effect of the favourable weather conditions that prevailed during 1993. Following increased nut production, the nut equivalent of desiccated coconut production rose by 41 per cent to reach 380 million nuts. The nut equivalent of coconut oil production, which followed a declining trend after 1990, improved significantly with a near three-fold increase to register 480 million nuts in 1994. The nut equivalent of copra exports and fresh nut exports too increased by 29 per cent and 18 per cent, respectively, to 31 million and 26 million nuts in 1994. Domestic nut consumption is estimated to have increased by 1 per cent to 1,687 million nuts, accounting for 65 per cent of the total nut production in 1994.

The production of most of the important minor export crops, except coffee and cardamoms, more or less remained unchanged when compared with the previous year. Coffee production, which recorded a 39 per cent decline in the previous year, improved significantly by 83 per cent to reach 3,687 metric tons in 1994. The improvement in coffee production is attributed to the favourable weather conditions and the enhanced application of fertilizer in 1994. Cardamom production, which declined by 30 per cent in 1993, recorded a 33 per cent increase to 40 metric tons in 1994. The output of cinnamon quills recorded a 2 per cent growth to 9,696 metric tons, while the output of cocoa too increased marginally to 1,463 metric tons. The output of cloves and nutmeg remained unchanged at the 1993 level. Pepper, which recorded a peak production in 1993, recorded a marginal drop in output to 4,694 metric tons in 1994.

Paddy production, estimated at 2.68 million metric tons (129 million bushels) in 1994, was an increase of 4.4 per cent over the production of the previous year. This was the highest production level recorded so far, surpassing the previous peak production recorded in 1985 by 23 thousand metric tons (1.1 million bushels). Paddy production in Maha 1993/94, estimated at 1.67 million metric tons (80 million bushels), was one per cent lower than the output of the previous Maha season, due to a reduction in average yield. Paddy production in Yala, which rose by 24 per cent in 1993, increased by a further 16 per cent to over one million metric tons (49 million bushels) in 1994. In spite of a decrease in the average yield, paddy production rose during the Yala season due to an increase in the extent sown and harvested. The rice equivalent of paddy produced, after adjusting for wastage and seed requirements, amounted to 1,606,000 metric tons. This accounted for 87 per cent of the estimated annual consumption in 1994 in comparison to 84 per cent in the previous year. Following increased production, rice imports declined to 58,000 metric tons in 1994 from 209,000 metric tons in 1993.

Sugar production at 72,275 metric tons in 1994, was the highest ever production recorded so far and 5 per cent higher than the production in 1993. As in the previous year, Hingurana, Sevanagala and Pelwatta Sugar Plantations contributed to the improvement in output. The production at Hingurana increased by 9 per cent to 14,058 metric tons. The production at Sevanagala, which increased by 17 per cent in 1993, recorded a similar increase to reach 18,535 metric tons in 1994. The output at Pelwatta increased marginally to 39,682 metric tons in 1994. No production was recorded at the Kantale sugar factory during the period under review. An increase in the quantity of cane crushed contributed to the growth in production.

The Minor food crop sector showed a mixed performance in 1994. Big onion production recorded a more than two-fold increase to 81,000 metric tons, while soya bean, ground nut and kurakkan production increased by 46 per cent, 33 per cent and 9 per cent, respectively. The significant expansion in the production of big onions, soya beans and ground nuts is attributed to the increased extents cultivated under these crops. Meanwhile, other minor food crops, such as chillies, potatoes, red onions, green gram, black gram, cowpea, gingelly and maize recorded decreased production during 1994.

Estimated fish production in 1994 at 224,000 metric tons, was an increase of one per cent when compared with the previous year. Output of the coastal fishery sub-sector, which accounted for 78 per cent of the total fish production, increased by 3 per cent from 169,900 metric tons in 1993 to 174,500 metric tons in 1994. Production of the offshore and deep sea sub-sector rose by

14 per cent to 37,500 metric tons. In contrast, the production of the inland fishery sub-sector dropped by 33 per cent to 12,000 metric tons and accounted for only 5 per cent of the total fish production in 1994 compared to 19 per cent recorded in 1989.

Industry

The expansion in the industrial sector moderated in 1994 under the impact of the uncertainties in the availability of quotas in certain categories of garments to the USA, disruptions in industrial activity during the latter part of the year and an unfavourable macro economic environment in the midst of national elections. The value of industrial output in real terms increased by 9 per cent in comparison to a growth of 14 per cent in the previous year. Private sector industrial output, generating a growth of 11 per cent, continued to outpace the industrial growth of the public sector which recorded a decline of 5 per cent in 1994.

The value of production of private sector industries, which grew by 13 per cent in real terms in 1993, expanded by 11 per cent in 1994. The output of the textile, wearing apparel and leather products sub-sector, which originated entirely from private sector industries, expanded by 6 per cent in 1994 compared to a growth of 17 per cent in the previous year. The creation of excess capacity in the garment sector without a proper assessment of quota availability had an adverse impact on the performance of this sector in 1994. Low prices fetched by the export oriented industries and labour disputes that prevailed in certain major textile and garment enterprises also contributed to the decline in the value of output in the garment sector. Leather products recorded a significant increase in output during the year mainly due to the improved performance of the BOI enterprises engaged in the manufacture of these products. The output of the food, beverages and tobacco category, which constituted nearly 26 per cent of the private sector industrial output, grew by 8 per cent in 1994, largely reflecting the improved production of dairy products, biscuits, confectionery, flour, processing of fruits and vegetables and meat products. In contrast, the output of tobacco products, which was the highest contributor to the total output of the food, beverages and tobacco category, recorded a marginal decline in 1994 caused by a labour dispute and a fall in domestic demand. The production of poultry feed recorded a decline primarily due to labour unrest in the major manufacturing enterprise.

The output of private sector industries in the chemicals, petroleum, rubber and plastic products category accounted for about a half of the total output of this sub-sector in 1994. Private sector industries engaged in the manufacture of agro-chemicals, pharmaceuticals, rubber and plastic products, soap and toiletries recorded high production. The export oriented BOI industries manufacturing industrial and surgical gloves and plastic products also recorded an improved performance in 1994.

Private sector industries, which contributed about four-fifths of the total output of the non-metallic mineral products sub-sector, continued to expand in 1994. Increased output levels were recorded in private sector industries engaged in the manufacture of cement, glass and glass products and asbestos following increased demand arising from the improved level of construction activities during the year. However, the output of ceramic products declined in 1994 owing to labour unrest. The export-oriented BOI industries engaged in the manufacture of dolomite products, porcelain figurines and granite slabs showed an improved performance in output.

Private sector industries in the paper and paper product sub-sector recorded a growth of 16 per cent in output in 1994. This increase originated largely from industries engaged in printing and manufacturing of paper and paper products, labels and packing materials. The output of the fabricated metal products sub-sector, which recorded a poor performance in the previous year, showed a substantial increase of 14 per cent in 1994 due to the improved performance of private sector industries manufacturing fabricated metal, electrical appliances, batteries, cables and bulbs. Increased output levels were also recorded in private sector industries engaged in the fabrication of coach work of buses and lorries.

In real terms, the public sector industrial output declined by 5 per cent in 1994, in contrast to a 20 per cent increase in the previous year. This was mainly the result of a sharp decline in the output of the non-metallic mineral products category following the transfer of ownership of cement and ceramic production units from the public sector to the private sector in December 1993. The Ceylon Petroleum Corporation (CPC), which accounted for about 78 per cent of the total public sector industrial output, recorded a 4 per cent increase in 1994. When petroleum is excluded, public sector industrial output is estimated to have declined by 33 per cent.

Prices

The rate of increase in the general level of prices, measured in terms of the Colombo Consumers' Price Index (CCPI) was 8.4 per cent 1994, compared to a rise of 11.7 per cent in 1993. Prices in the food, clothing, fuel and light, and miscellaneous sub categories of the CCPI increased at a slower rate in 1994 than in 1993. The reduction in administrative prices largely contributed towards the slowing down in the rate of price increase in the food sub category to a single digit level. The prices of bread and wheat flour were reduced during the latter half of the year, while the import duties on some consumer items such as lentils, sugar and dried fish were either waived or reduced. There was also a downward revision in the prices of kerosene and diesel. These price and duty reductions coupled with a moderation in the price increase of rice and a drop in the prices of chillies and coconut as well as a slowing down in price increases in the clothing and miscellaneous categories helped to contain the rate of inflation during the year. However, with a 19.6 per cent increase in the Broad Money supply, the demand pressure on the general price level continued unabated.

In 1994 as in 1993, the Greater Colombo Consumers' Price Index (GCPI) showed a much lower increase than the CCPI. The annual average increase of the Index for 1994 was 4.8 per cent compared with 8.4 per cent in 1993. Food prices, according to the GCPI, rose by 4.0 per cent during the year compared with 8.7 per cent in the previous year. In the fuel & light category of the GCPI, prices rose by 17.0 per cent, a similar increase to that of the preceding year. The rise in prices in the clothing and footwear category at 3.9 per cent was significantly lower than the increase of 8.2 per cent registered in 1993. Increases in prices in the liquor, tobacco, betel and arecanut, personal care, health services, household goods and services, and transport and communication categories at 8.2 per cent, 6.7 per cent and 0.5 per cent, respectively, were also lower than the increases displayed by these categories in the previous year.

The Wholesale Price Index (WPI), which measures price movements at the primary market level, rose by 5.0 per cent in 1994 compared to an increase of 7.6 per cent in 1993. The decline in the prices of major export commodities -tea and coconut-largely contributed to the deceleration in the rate of increase in prices experienced during the year. Prices in the food sub group declined marginally during the year, while prices in the alcoholic drinks, textiles and footwear, chemical and chemical products, and petroleum products too slowed down when compared with the increases recorded in the previous year. Sharp price increases were registered in the non-metallic products, fuel & light and miscellaneous categories during the year.

Wages

The movement of wages in the government sector is measured by the wage rate indices for government sector employees. In nominal terms, the wage rate index for all central government employees grew by 8.9 per cent during 1994. In real terms, wages of this category of employees rose marginally by 0.5 per cent. In 1993, however, nominal wages grew sharply by 21.1 per cent and real wages by 8.3 per cent following the implementation of the new salary scales. Nominal wage rate indices for all non-executive officers rose by 11.3 per cent in 1994 while their real wages improved by 2.8 per cent. The rectification of anomalies for clerical and allied grades and the middle level technical service in August 1994 was responsible for the growth in wages of non-executive grades. The wage rate index for minor employees grew by 6.0 per cent in 1994, representing a decline in real wages by 2.2 per cent. The wage rate index for government school teachers rose by 5.0 per cent during the year. In real terms, this represented a wage deterioration of 3.0 per cent.

In 1994, wage growth for workers covered by Wages Boards decelerated to 3.9 per cent from 16.2 per cent in 1993. Real wages for workers covered by Wages Boards deteriorated by 4.2 per cent during 1994, whereas in the previous year, real wages improved by 4.1 per cent. Workers in Agriculture experienced a nominal wage growth of 2.2 per cent in 1994 which represented a real wage deterioration of 5.7 per cent. In the previous year, wages for workers in Agriculture grew substantially by 21.1 per cent in nominal terms, while real wages improved by 8.3 per cent. Wages for workers in State Plantations remained unchanged since the grant of the budgetary allowance of Rs.12/- and the freezing of the Cost of Living Allowance payable to these workers in January 1993. Wages for workers in Services grew very sharply during the year by 17.9 per cent in nominal terms while their real wages improved by 8.7 per cent. The growth in wages for workers in Industry and Commerce, at 5.2 per cent in 1994, was higher than the increase registered in the preceding year (3.4 per cent). Minimum wages for workers in the Nursing Homes, Textile Manufacturing and Motor Transport Trade categories were revised upwards in 1994.

The nominal wages in the unorganised sector for all activities increased in 1994. In paddy cultivation, the rates of growth varied between 8 to 17 per cent. Real wages improved in almost all activities in paddy cultivation. In coconut cultivation, nominal wages grew substantially, resulting in an improvement in real wages. In comparison, growth in wages in tea and rubber cultivation was relatively slow with real wages deteriorating in several activities. In building construction activities, nominal wages increased at rates ranging between 10 to 11 per cent for all categories of labour.

Employment

According to the Annual Employment Survey conducted by the Central Bank of Sri Lanka, the total employment in the public sector, which includes the government and the semi-government sectors, increased moderately by 2 per cent to around 1.32 million as at end 1994. Employment in government institutions, consisting of the Central Government, Ministries and Departments as well as Provincial Councils and Local Authorities, estimated at 699,898 registered an increase of 3.5 per cent over 1993. The increase was largely reflected in the category of doctors and health personnel and in the category of clerical and related workers which showed increases of 8 per cent and 6 per cent, respectively, over the previous year. The service workers category, consisting of mainly defence personnel, increased by 4 per cent. Employment in semi-government institutions including Public Corporations, Statutory Boards, Government Owned Business Undertakings and State Banks rose by a marginal 1 per cent during 1994 reflecting increases in clerical, professional and technical categories.

The Board of Investment of Sri Lanka (BOI) provided employment for 134,572 persons at the end of 1994, recording an increase of 10 per cent over 1993. Around 43 per cent of the employment in these enterprises was in the Katunayake Export Promotion Zone. The Biyagama and Koggala Export Promotion Zones provided employment for 16 per cent and 4 per cent, respectively.

Trade and Balance of Payments

The external trade sector was affected by several adverse developments in 1994. Under the impact of uncertainties in the availability of quotas in certain categories of garments to the USA, disruptions in industrial activity, a deterioration in macro economic conditions and high demand pressures in the economy, export growth moderated to 9 per cent in 1994 from 17 per cent in 1993, while imports increased by 16 per cent. A deterioration in the external terms of trade by 4.7 per cent in 1994, in contrast to an improvement of 2.0 per cent in 1993, also contributed to the slower growth in the value of exports and higher growth in imports. These developments led to an increase in the trade deficit from 11 per cent of GDP in 1993 to 13 per cent of GDP in 1994.

In spite of an increase in the volume of tea exports from 218 million kg in 1993 to 230 million kg, the value of tea exports rose only marginally from SDR 295 million (Rs.19,911 million) in 1993 to SDR 296 million (Rs.20,964 million) in 1994 as a result of a decline in the average export price by 4 per cent to SDR 1.29 per kg (Rs.91.32 per kg) in 1994. However, despite a marginal decline in the volume of rubber exports to 69 million kg, the value of rubber exports increased by 11 per cent to SDR 51 million (Rs.3,582 million) in 1994 due to an increase in the average export price by 11 per cent to SDR 0.73 per kg (Rs.51.81 per kg) following favourable international prices for natural rubber.

Total earnings from the export of coconut products rose by 29 per cent from SDR 41 million (Rs.2,796 million) in 1993 to SDR 53 million (Rs.3,761 million) in 1994, reflecting a marked increase in the volume of exports by 49 per cent, from a nut equivalent of 293 million in 1993 to 436 million in 1994. However, the average export price per nut declined by 11 per cent from SDR 0.09 per nut in 1993 to SDR 0.08 per nut in 1994 following global supply improvements. The value of export earnings of coconut by-products including coir fibre and coir yarn also increased by 29 per cent in 1994.

The value of minor agricultural exports rose from SDR 86 million (Rs.5,825 million) in 1993 to SDR 90 million (Rs.6,385 million) in 1994. In spite of a 57 per cent increase in volume, the earnings increased by only 5 per cent as the average export price of minor agricultural products registered a sharp drop of 33 per cent in 1994.

The value of industrial exports in 1994 at SDR 1,646 million (Rs.116,744 million), was an increase of 11 per cent over the value of SDR 1,487 million (Rs.100,420 million) in 1993. In 1993, the value of industrial exports grew by 20 per cent. The earnings from textile and garment exports rose by 7 per cent from SDR 1,009 million (Rs.68,150 million) in 1993 to SDR 1,080 million (Rs.76,614 million) in 1994. The deceleration in growth in the earnings of textiles and garments in 1994 in comparison with the 17 per cent increase in 1993 was partly a reflection of uncertainties regarding the quotas in certain categories of garments to the USA in the latter part of 1994 and the increase in the share of exports of low valued items in the composition of garment exports.

The other industrial exports, with a high content of domestic value addition, rose by 21 per cent to SDR 510 million (Rs.36,171 million) in 1994. In this category, substantial increases were recorded in jewellery (96 per cent), leather, rubber, paper, wood and ceramics (33 per cent), food, beverages and tobacco (29 per cent) and machinery, mechanical and electrical appliances (19 per cent). The value of exports of petroleum products and diamonds remained more or less at the 1993 level. Earnings from mineral exports showed an 11 per cent increase from SDR 54 million (Rs.3,653 million) in 1993 to SDR 60 million (Rs.4,293 million) in 1994. This was largely due to increased earnings from exports of gems by 10 per cent from SDR 50 million (Rs.3,402 million) in 1993 to SDR 55 million (Rs.3,917 million) in 1994. The earnings from other mineral exports rose from SDR 4 million (Rs.251 million) to SDR 5 million (Rs.375 million) owing to increases in exports of ilmenite, metallic ores and iron pyrites.

The total expenditure on imports rose by 16 per cent to SDR 3,328 million (Rs.236,030 million) in 1994 from SDR 2,870 million (Rs.193,550 million) in 1993, reflecting increases in all major categories of imports.

Reflecting high demand pressure in the economy, the outlay on imports of consumer goods rose sharply by 17 per cent from SDR 555 million (Rs.37,372 million) in 1993 to SDR 650 million (Rs.45,983 million) in 1994. The expenditure on durable consumer goods, which grew by 21 per cent, was the major contributory factor to the increase in consumer goods. In the durable consumer goods category, high growth rates were recorded for motor cars and cycles (79 per cent), and radio receivers & television sets (10 per cent). The import outlay on food and beverages too rose by 13 per cent.

Spurred by high economic activity, expenditure on the import of intermediate goods rose by 10 per cent to SDR 1,694 million (Rs.119,970 million) in 1994. Major increases were recorded in textiles and clothing by 17 per cent from SDR 617 million (Rs.41,740 million) in 1993 to SDR 724 million (Rs.51,299 million) in 1994 and in fertilizer by 21 per cent from SDR 46 million (Rs.3,108 million) to SDR 56 million (Rs.3,885 million). Increases were also recorded in other industrial raw materials such as dyeing, tanning & colouring products (7 per cent), chemical elements & compounds (9 per cent), other intermediate goods (12 per cent) and paper and paper boards (13 per cent). The impact of these increases was partly offset by declines recorded in the import outlay on wheat grain and petroleum by 12 per cent and 7 per cent, respectively. The drop in expenditure on wheat grain imports was a reflection of a decline in the import prices by 18 per cent which more than offset a 7 per cent increase in the import volume. The decline in the import outlay on petroleum was largely due to a drop in the average import price of crude oil by 10 per cent.

The outlay on investment good imports increased significantly by 27 per cent from SDR 750 million (Rs.50,508 million) in 1993 to SDR 949 million (Rs.67,524 million) in 1994 largely due to the importation of two air crafts to the value of SDR 150 million (Rs.11,260 million). When this exceptional item was excluded, total investment good imports registered an increase of 16 per cent in 1994. The value of transport equipment excluding the value of aircrafts increased by 2 per cent. Meanwhile, the import outlay on machinery and equipment increased by 18 per cent from SDR 332 million (Rs.22,377 million) in 1993 to SDR 390 million (Rs.27,635 million) in 1994 partly reflecting the effects of tariff reductions to boost imports under this category. Building materials rose by 21 per cent from SDR 138 million (Rs.9,342 million) to SDR 168 million (Rs.11,898 million) between the two years. The imports of other investment goods, which accounted for 8 per cent of total investment goods, also rose by 40 per cent to SDR 78 million (Rs.5,566 million) in 1994.

In the services account, receipts increased from SDR 535 million in 1993 to SDR 627 million in 1994, while payments rose from SDR 507 million to SDR 615 million. This was in sharp contrast to the performance in 1993 when payments increased at a slower rate. Accordingly, the surplus in the services account declined from SDR 28 million (Rs.1,821 million) in 1993 to SDR 12 million (Rs.820 million) in 1994. On the receipts side, an improved performance was recorded in all major categories of services, particularly in the case of port, transportation and insurance, travel and other services. With the tourist arrivals exceeding the peak level recorded in 1982 and an increase in the average spending per day per tourist, the receipts on account of travel increased by 10 per cent to SDR 161 million in 1994 compared with a 5 per cent growth observed in 1993. However, there was also a substantial increase in the outflows on account of travel reflecting increased travel abroad by Sri Lankan residents. As a result, net receipts on account of travel declined from SDR 60 million to SDR 43 million.

Investment income inflows rose by 27 per cent to SDR 100 million in 1994 reflecting increased investment income earned on foreign asset holdings of the Central Bank of Sri Lanka which rose from SDR 1,194 million in 1993 to SDR 1,373 million in 1994. As regards outflows, interest payments rose by SDR 17 million to SDR 161 million and profit and dividends increased by SDR 28 million to SDR 51 million. This was in contrast to the pattern observed in the previous year when a significant portion of profit and dividends was retained in Sri Lanka due to high rates of return on investment.

Net inflows in the transfers account, particularly those in respect of private transfers continued to be a major source of foreign inflows to the country. Private transfers which accounted for around 14 per cent of the total receipts on goods, services and transfers, increased from SDR 454 million (Rs.30,592 million) in 1993 to SDR 499 million (Rs.35,345 million) in 1994 largely reflecting the continued increase in the remittances by Sri Lankan migrant workers particularly in the Middle East. However, the rate of increase in inflows of private transfers declined from 17 per cent in 1993 to 10 per cent in 1994. This may be partly attributed to the moderation of interest sensitive transfers in response to a decline in domestic interest rates and an increase in interest rates in major international markets in 1994. Meanwhile, outflows on account of private transfers increased from SDR 52 million (Rs.3,501 million) in 1993 to SDR 61 million (Rs.4,357 million) in 1994 as the full impact of the relaxation of restrictions in 1993 on the transfer of assets by Sri Lankan migrants was felt in 1994. Official transfers remained at the 1993 level of SDR 115 million. As the combined outcome of the private and official transfers, net inflows in the transfers account increased from SDR 517 million (Rs.34,839 million) in 1993 to SDR 552 million (Rs.39,057 million) in 1994.

Reflecting the deterioration in the trade account and narrowing of the surplus in the invisibles balance (services and net foreign transfers), the current account deficit widened from SDR 281 million (Rs.18,825 million) in 1993 to SDR 531 million (Rs.37,767 million) in 1994. As a ratio of GDP, the deficit increased from 3.8 per cent to 6.5 per cent between 1993 and 1994. This ratio excluding grants increased from 5.3 per cent in 1993 to 7.9 per cent in 1994. This sharp deterioration in the current account after two years of continued improvement was a worrisome development in the Balance of Payments in 1994 as it was largely attributed to a high demand pressure build up in the economy during 1994.

Following the surge in capital inflows experienced in 1993, there was a substantial moderation in inflows in the capital account in 1994, largely reflecting an uncertain domestic political and economic environment. Net non-monetary capital inflows increased only by 10 per cent to SDR 674 million in 1994 compared with an increase of 61 per cent recorded in 1993. There was a marked reduction in inflows to the private sector on account of direct foreign investment and portfolio investment and in loans disbursed to the government.

Despite a continued expansion in the enterprises under BOI, as indicated by the number of new enterprises under commercial operations increasing from 94 in 1993 to 137 in 1994, direct foreign investment has been estimated to have declined to SDR 111 million in 1994 from SDR 134 million in 1993. Net inflows of foreign capital on portfolio investment also declined from SDR 48 million in 1993 to SDR 20 million in 1994. In fact, sales of shares by non-residents at the Colombo Stock Exchange exceeded purchases in the months of March, April and the last quarter of 1994. This substantial reduction in portfolio investment was a reflection of an improved investment climate in developed countries and the policy slippages in the midst of national elections which led the investors to follow a cautious attitude.

Net capital inflows to government, the bulk of which consisted of foreign concessional financial assistance, recorded a decline of 23 per cent from SDR 190 million (Rs.12,579 million) in 1993 to SDR 146 million (Rs.10,348 million) in 1994 largely reflecting a reduced recourse to non-concessional loans. Though total foreign capital inflows (gross) to the Government declined

TABLE 1.3
Summary of Balance of Payments 1991 - 1994

Rs. Million (SDR Million in brackets)

Item	1991	1992	1993(a)	1994(b)
Merchandise (Net)	-41,252	-45,785	-55,486	-77,644
	(-726)	(-740)	(-825)	(-1,095)
Non-Factor Services (Net)	3,594	6,391	7,800	8,848
	(65)	(104)	(116)	(125)
Factor Services (Net)	-7,367	-7,821	-5,979	-8,028
	(-130)	(-127)	(-88)	(-113)
Private Transfers (Net)	16,623	20,253	27,090	30,989
	(293)	(328)	(402)	(438)
Official Transfers (Net)	8,407	8,027	7,749	8,069
	(148)	(130)	(115)	(115)
Current Account Balance	-19,995	-18,935	-18,825	-37,767
	(-352)	(-306)	(-281)	(-531)
Overall Balance	10,140	9,469	24,149	17,166
	(152)	(133)	(375)	(173)
Some Key Indicators				
Terms of Trade (1985 = 100)	85.7	89.1	90.9	86.6
Net Petroleum Imports	9,598	11,167	11,119	10,682
	(170)	(180)	(165)	(151)
Current Account Deficit as a percentage of G.D.P	-5.4	-4.5	-3.8	-6.5
Gross International Reserves	49,223	66,236	105,258	130,340
	(809)	(1,047)	(1,544)	(1,792)
International Reserves in Months of Current Imports	4.4	5.1	6.5	6.5

(a) Revised
(b) Provisional

Source : Central Bank of Sri Lanka

from SDR 334 million in 1993 to SDR 283 million in 1994, disbursements of project loans increased from SDR 192 million to SDR 259 million.

In contrast to these developments, private long term and short term capital inflows continued to increase significantly. Private long term capital inflows increased by SDR 64 million to SDR 281 million in 1994. This included major inflows providing foreign financing towards the Air Lanka Refleeting Program and the government sponsored bus assembly project and to BOI projects in the form of loan capital. The private long term capital outflows declined from SDR 83 million in 1993 to SDR 65 million in 1994.

Net inflows of private short term capital increased significantly from SDR 105 million in 1993 to SDR 182 million in 1994. The short term capital inflows in 1994 included FCBU credits to BOI enterprises toward their working capital and trade credits including credit facilities to BOI enterprises towards financing their raw material imports.

External Assets

Sri Lanka's gross external assets recorded a 16 per cent increase to SDR 1,792 million (Rs.130,340 million) at the end of 1994 from SDR 1,544 million (Rs.105,258 million) at the end of

1993 reflecting the modest net inflow of foreign capital during the year and the net inflow of SDR 47 million from the IMF under the ongoing enhanced Structural Adjustment Facility (ESAF). Gross official reserves, comprising foreign assets held by the Central Bank and the Government increased by SDR 172 million to SDR 1,389 million between the two years. Gross external assets at the end of 1994 were sufficient to finance 5.9 months of imports projected for 1995, while gross official reserves were equivalent to 4.6 months of projected imports.

Exchange Rate Movements

During 1994, the Sri Lanka Rupee (SLR) fluctuated against all major international currencies except the Japanese Yen against which it depreciated throughout the year. The movements of the Rupee reflected the fluctuations in the cross rates of major currencies due to volatile conditions in international foreign exchange and financial markets as well as the conditions that prevailed in the foreign exchange market in Sri Lanka. Compared with end 1993, the US dollar depreciated sharply against the Yen, Deutsche Mark, French Franc and the Pound Sterling in 1994. Accordingly, the Rupee depreciated by 0.8 percent against the US dollar, the intervention currency from end 1993 to end 1994. However, against the relatively stronger currencies in the international market, the Rupee depreciated at a higher rate, *i.e.* against the Japanese Yen by 11.4 per cent, the Deutsche Mark by 10.7 per cent, the French Franc by 9.1 per cent and the Pound Sterling by 5.8 per cent. It also depreciated by 1 per cent against the Indian Rupee. The composite outcome of the movements against major currencies was the depreciation of the Sri Lanka Rupee by 6.3 per cent against the SDR compared with 7.1 per cent in the previous year.

Sri Lanka's Nominal Effective Exchange Rate (NEER) defined as the trade weighted nominal exchange rate with respect to major trading partners, depreciated by 5.1 per cent on a point to point basis from December 1993 to December 1994. The Real Effective Exchange Rate (REER) which is the nominal exchange rate adjusted for inflation differentials between Sri Lanka and the major trading partners, depreciated by 3.2 per cent on the same basis during the year.

External Debt

The external debt of Sri Lanka at the end 1994 was estimated at SDR 6,089 million, recording an increase of SDR 504 million from end 1993 to end 1994. This increase reflected largely the increase in long term and short term lending to the private sector during 1994. Medium and long term loans of the Government, which accounted for 69 per cent of the outstanding loans at end 1994, increased by SDR 69 million mainly on account of concessional assistance extended by Japan, the ADB and the IDA. In 1994, Sri Lanka received the first tranche under the third year arrangements of the Enhanced Structural Adjustment Facility (ESAF) with the IMF, amounting to SDR 56 million. With the repayment of SDR 9 million of a loan taken earlier under the Structural Adjustment Facility (SAF), the outstanding debt to the IMF increased by SDR 47 million to SDR 423 million at the end of 1994.

Debt Service Payments

Debt service payments which included amortization of medium and long-term loans and interest payments on all foreign loans, increased by 4 per cent to SDR 372 million in 1994. However, with the increase in earnings from the export of goods and services during the year , the debt service ratio decreased from 13.8 per cent to 13.0 per cent between the two years. Debt service payments, as a ratio of receipts from the exports of goods, services and private transfers, declined from 11.8 per cent in 1993 to 11.1 per cent in 1994.

Government Finance

There was a relaxation of fiscal policy in 1994 as events unfolded towards national elections. In spite of the commitment to consolidate government fiscal operations by generating a surplus in current account operations equivalent to 1.1 per cent of GDP and containing the overall budget deficit at 6.8 per cent of GDP, a weakening of revenue efforts and relaxed expenditure policies led to a significant increase in the current account deficit to 2.9 per cent of GDP, and the overall Budget deficit to 10 per cent of GDP, requiring a very high level of domestic borrowings.

In 1994, government revenue totalled Rs.110,038 million registering an increase of 12 per cent in comparison with 15 per cent in the previous year. Consequently, the government revenue/GDP ratio declined from 19.7 per cent in 1993 to 19.0 per cent in 1994. Total tax revenue at Rs.99,417 million accounted for 90 per cent of government revenue in 1994. The importance of taxes on goods and services within the tax revenue structure also further strengthened with the increase in such revenue from Rs.47,963 million (56 per cent) to Rs.56,685 million (57 per cent) in 1994. Underpinning this development was the increased revenue collection from the Defence Levy and excise taxes. Import duty collections, at Rs.22,598 million, recorded a 9 per cent increase and accounted for 23 per cent of tax revenue in 1994. Meanwhile, reflecting a buoyant growth, income taxes increased from Rs.12,543 million in 1993 to Rs.15,277 million in 1994 in spite of a reduction in the maximum income tax rate from 40 per cent to 35 per cent in April 1994.

Non-tax revenue at Rs.10,621 million, was a decline of 15 per cent over the previous year. Interest income accounted for nearly 43 per cent of non-tax revenue, while Central Bank profit transfers, profits and dividends including the levies under the Finance Act on the Ceylon Petroleum Corporation and the Sri Lanka Telecom and fees and charges generated a further 37 per cent of non-tax revenue in 1994.

Total government expenditure at Rs.167,768 million (29 per cent of GDP), recorded an increase of 19 per cent from Rs.140,460 million (28.1 per cent of GDP) in the previous year. Current expenditure amounting to Rs.127,084 million accounted for 22 per cent of GDP in 1994 in comparison to 20.5 per cent in the previous year. Meanwhile, public investment at Rs.40,455 million when defined in relation to GDP, declined to 7 per cent in 1994 from 8 per cent in 1993.

Current expenditure at Rs.127,084 million, showed a sharp increase of 24 per cent in 1994 in comparison to a 14 per cent growth in the previous year. The expenditure on account of salaries, travelling, supplies and requisites *etc.* totalling Rs.54,700 million, recorded a 22 per cent increase compared with 13 per cent in the previous year due to an increased level of defence expenditure and enhanced outlays on general administration. Reflecting the high cost of successive budget deficits which resulted in high borrowings each year, interest payments on government debt at Rs.38,031 million, recorded an increase of 26 per cent in 1994. Under the impact of the high cost of pensions and expansion in various welfare expenditure programmes during the year, particularly after the announcement of the relief measures in May 1994, total transfer payments to households, including pensions and welfare expenditure programmes at Rs.28,263 million, witnessed a rise of 27 per cent.

In the context of a weaker revenue effort and high current expenditure, the current account of the budget generated an unprecedently high deficit of Rs.17,046 million - a major reversal of the recent trend towards reducing such imbalances. Thus, the current account deficit, which declined from 2.0 per cent of GDP in 1991 to 0.8 per cent of GDP in 1993, rose to 2.9 per cent of GDP in 1994, reflecting a high consumption orientation in government fiscal operations.

TABLE 1.4
Summary of Government Fiscal Operations

Rs. Million

Item	1990	1991	1992	1993	1994 Provisional
Total Revenue	67,964	76,179	85,781	98,339	110,038
Tax Revenue	61,206	68,157	76,353	85,891	99,417
Non-Tax Revenue	6,758	8,022	9,428	12,448	10,621
Total Expenditure & Net Lending	99,814	119,527	116,973	140,460	167,768
Recurrent	71,771	83,756	89,639	102,288	127,084
Capital & Net Lending	28,043	35,771	27,334	38,172	40,684
Current Account Surplus/ Deficit (-)	-3,807	-7,577	-3,858	-3,949	-17,046
Deficit (before grants)	-31,850	-43,348	-31,192	-42,121	-57,730
Financing	31,850	43,348	31,192	42,121	57,730
Foreign Grants	6,697	7,870	8,280	8,025	8,257
Foreign Borrowings	11,645	19,329	7,361	9,855	11,778
Domestic Financing	13,508	16,149	15,551	24,241	37,696
Non Bank	13,251	16,114	17,873	30,320	36,539
Bank	257	35	-2,322	-6,079	1,157
			GDP Ratios (%)		
Total Revenue	21.1	20.4	20.2	19.7	19.0
Tax Revenue	19.0	18.3	17.9	17.2	17.2
Non-Tax Revenue	2.1	2.2	2.2	2.5	1.8
Total Expenditure and Net Lending	31.0	32.1	27.5	28.1	29.0
Recurrent	22.3	22.5	21.1	20.5	22.0
Capital & Net Lending	8.7	9.6	6.4	7.6	7.0
Current Account Surplus/ Deficit (-)	-1.2	-2.0	-0.9	-0.8	-2.9
Deficit (before grants)	-9.9	-11.6	-7.3	-8.4	-10.0
Financing	9.9	11.6	7.3	8.4	10.0
Foreign Grants	2.1	2.1	1.9	1.6	1.4
Foreign Borrowings	3.6	5.2	1.7	2.0	2.0
Domestic Financing	4.2	4.3	3.7	4.9	6.5
Non-Bank	4.1	4.3	4.2	6.1	6.3
Bank	0.1	...	-0.5	-1.2	0.2

Source: Central Bank of Sri Lanka

Capital expenditure and net lending in 1994 amounted to Rs.40,684 million or 7.1 per cent of GDP, compared with Rs.38,172 million or 7.6 per cent in the previous year. Public investment totalled Rs.40,455 million (7.0 per cent of GDP) in 1994 compared to Rs.39,927 million (8.0 per cent of GDP) in 1993. The low level of public investment is a disconcerting feature in fiscal developments in recent years as there was a persistent decline in the public investment/GDP ratio from 10.5 per cent in 1989 to 7 per cent in 1994. In the context of an urgent need for infrastructure facilities and considerable donor support for Sri Lanka's public investment, it is essential that public investment is maintained at durable levels.

Revenue and expenditure flows resulted in a deficit of Rs.57,730 million or 10 per cent of GDP in comparison to a deficit of Rs.42,121 million or 8.4 per cent of GDP in 1993. The budget deficit (after grants) at Rs.49,473 million in 1994, was an increase of 45 per cent over the previous year's deficit of Rs.34,096 million. Net borrowings from foreign sources amounted to Rs.11,778 million as against Rs.9,855 million in 1993, and as a proportion of GDP, remained at 2.0 per cent as in the previous year. Reflecting a large resource gap in the government budgetary operations, particularly in current account transactions, domestic borrowings at Rs.37,696 million, showed a phenomenal rise of 56 per cent in 1994. Consequently, domestic financing in relation to GDP rose from 4.9 per cent in 1993 to 6.5 per cent in 1994 increasing further the debt burden on the budget.

In the context of a large resource gap in fiscal operations in 1994, the Government had to resort to the banking system for financing the budget deficit. In spite of a build up of government cash balances of Rs.1,011 million in the Central Bank, the use of Central Bank provisional advances to the value of Rs.1,864 million, a further borrowings through Treasury bills to the tune of Rs.1,145 million and other transactions resulted in a net borrowing of Rs.1,157 million in 1994, contributing to an expansion in reserve money (high powered money) in the economy. However, net credit to government from commercial banks declined by Rs.605 million, owing to a build up of government deposit balances by Rs.2,986 million in 1994, in spite of an increase in government borrowings from the commercial banks by Rs.2,381 million.

The outstanding value of Government debt at the end of 1994 at Rs.549,292 million, was an increase of 14 per cent. The total debt/GDP ratio was 95 per cent in 1994 compared to 97 per cent in 1993. The total domestic debt which accounted for 45 per cent of the government debt, rose by 17 per cent from Rs.213,685 million at the end of 1993 to Rs.249,118 million at the end of 1994 while foreign debt increased by 11 per cent from Rs.270,224 million to Rs.300,174 million. Medium and long term domestic debt rose by Rs.28,552 million to Rs.140,392 million at the end of December 1994 while short term debt increased by Rs.6,881 million to Rs.108,726 million, reflecting a structural shift in the government debt profile towards medium and long term debt. As a result, the proportion of medium and long term debt in total domestic debt increased from 52 per cent in 1993 to 56 per cent in 1994. The total domestic debt in relation to GDP stood at the previous year's 43 per cent.

The debt service payments of the Government, consisting of Rs.22,671 million of amortisation payments and Rs.38,031 million of interest payments, totalled Rs.60,702 million registering an increase of 6 per cent over the previous year. Debt service payments as a ratio of GDP marginally declined to 10.5 per cent in 1994 from 11.5 per cent in 1993, largely due to a lower volume of maturing debt on account of Rupee securities. Debt repayment on account of foreign debt at Rs.7,606 million recorded an increase of 9 per cent over 1993.

Money Supply

The rate of growth of money supply continued to remain high during 1994 underscoring a persistently high demand pressure in the economy. The Narrow Money Supply (M_1) recorded an annual growth of 19 per cent at the end of the year, the same rate of growth registered in 1993, while the rate of growth of Broad Money Supply (M_2) moderated to 19.6 per cent in 1994 from the 23.5 per cent growth a year ago. Although there was some moderation in the growth of money supply during January-May 1994, monetary growth, on average, remained persistently high throughout the year.

A sustained rise in domestic credit was the prime cause for the continued high monetary expansion during 1994. Under the impact of private sector credit growth of 21 per cent and net public sector credit expansion of 4 per cent, domestic credit rose sharply by 14.7 per cent compared to a growth of 3.5 per cent at the end of the previous year. However, reflecting a lower surplus in the overall balance of payments, the growth in net foreign assets (NFA) moderated to 37.7 per cent from a sharp rise of 87.9 per cent in 1993, easing pressure on monetary expansion.

The monetary base expanded by 20.5 per cent (Rs.11,588 million) and reached Rs.68,055 million at the end of the year, in comparison with the high growth of 25.9 per cent (Rs.11,609) recorded in the previous year. On the source side, the accumulation of net foreign assets with the Central Bank, which grew by Rs.14,288 million, continued to be the main contributory factor for the expansion in reserve money. A reduction in Net Domestic Assets (NDA) of the Central Bank by Rs.2,700 million, mainly through the issuance of Central bank securities, and a gradual reduction in Central Bank refinance credit helped to contain the increase in reserve money to Rs.11,588 million in 1994 from Rs.11,609 million during the previous year. As a consequence of the higher growth in reserve money in relation to the growth in money supply, the money multiplier - the ratio between money supply and the monetary base - declined marginally from 2.86 at the end of 1993 to 2.84 at the end of 1994 underlining a strengthening of the transaction demand for money as was evident in the rise in the currency to deposit ratio from 24.8 per cent in 1993 to 25.2 per cent in 1994.

The Narrow Money Supply (M_1), comprising currency and demand deposits held by the public, at Rs.71,520 million at the end of 1994, was an increase of 19.0 per cent (Rs.11,416 million). A growth of 19.0 per cent (Rs.9,614 million) was experienced in the previous year as well. Reflecting a strengthening of the transaction demand for money, currency in circulation grew by 21 per cent (Rs.6,773 million) as against a rise of 18 per cent (Rs.4,853 million) in 1993, while demand deposits rose by 17 per cent (Rs.4,643 million) compared to a growth of 21 per cent (Rs.4,761 million) in the previous year. Accordingly, the share of currency in circulation in M_1 rose from 53 per cent in 1993 to 54 per cent at the end of 1994.

Meanwhile, in response to aggressive deposit mobilization efforts of commercial banks, time and savings deposits (quasi-money) held by the public with commercial banks grew by 20 per cent (Rs.20,212 million) compared with an increase of 26 per cent (Rs.21,047 million) in 1993. As in the previous years, a large share of the increase in deposits was contributed by a rise in deposits of private sector constituents, which rose by 19 per cent (Rs.16,768 million). Time and savings deposits of government corporations and co-operative institutions grew by 29 per cent (Rs.2,949 million) and 15 per cent (Rs.495 million), respectively. Accordingly, the Broad Money Supply (M_2), consisting of M_1 plus time and savings deposits held by the public, expanded by 19.6 per cent in 1994.

The high growth of credit to the private sector was the major contributory factor for high monetary expansion in 1994. Despite a reduction in credit to public corporations, domestic credit recorded a high growth of 14.7 per cent (Rs.23,336 million) in comparison to a 3.5 per cent (Rs.5,362 million) increase in the previous year largely due to a high credit growth of 21 per cent (Rs.23,917 million) to private sector constituents.

Domestic credit expansion was further fuelled by a 4.0 per cent (Rs.1,393 million) rise in net credit to government (NCG) extended by the banking system in 1994 in contrast to a significant decline of 17 per cent (Rs.7,346 million) in 1993. In spite of a build-up of government deposits by Rs.1,011 million and a reduction in cash items in process of collection by Rs.237 million, the NCG from the Central Bank increased by Rs.1,760 million due to the increased Treasury bill holdings of the Central Bank by Rs.1,145 million and an increase in provisional advances to the government of Rs.1,863 million, reflecting the adverse fiscal situation in 1994. Meanwhile, NCG from commercial banks declined during the period under consideration. Although there was an increase in gross credit to government from commercial banks by Rs.2,382 million, with an increase in government deposit balances by Rs.2,986 million, NCG from commercial banks declined by Rs.604 million.

Bank credit to public corporations declined by 33.6 per cent (Rs.2,612 million) in 1994. Reflecting an improved financial position largely due to lower international prices for crude oil, credit utilized by the Ceylon Petroleum Corporation (CPC) declined by Rs.2,400 million in contrast to an increase of Rs.416 million in 1993. In spite of a reduction in the wholesale price of wheat flour in July and again in August 1994, bank borrowings by the Co-operative Wholesale Establishment (CWE) increased only marginally by Rs.67 million due to favourable international wheat prices, particularly during the early part of the year, and the availability of wheat grain under concessional arrangements. Outstanding advances to the Ceylon Cement Corporation declined by Rs.384 million as a result of the privatisation of this corporation. Meanwhile, total bank credit to co-operative institutions increased from Rs.1,903 million in 1993 to Rs.2,541 million in 1994.

Under the impact of a surplus in the overall balance of payments position for the fifth consecutive year, the NFA of the banking system recorded a further rise of 37.7 per cent (Rs.17,102

TABLE 1.5
Monetary Magnitudes 1989 - 1994

Rs. Million

Item	1989	1990	1991	1992	1993	1994
Change in Domestic Credit	5,454	17,543	14,362	19,121	5,362	23,336
Increase in Net Credit to Government	54	3,078	2,595	558	-7,346	1,393
Increase in Credit to Government Corporations	3,075	1,774	-1,559	673	-6,975	-2,612
Increase in Credit to Co-operatives	-140	418	161	264	-118	638
Increase in Credit to other Private Sector	2,465	12,273	13,165	17,626	19,800	23,917
Change in Net External Banking Assets	-2,326	5,474	7,225	6,731	21,238	17,102
Change in Total Assets / Liabilities	3,128	23,017	21,587	25,852	26,599	40,438
Increase in Broad Money Supply (M_2)	8,487	14,584	21,080	18,604	30,661	31,628
Increase in other Liabilities (Net)	-5,359	8,433	507	7,248	-4,062	8,810
Percentage Increases in Monetary Magnitudes						
Percentage Increase in Total Domestic Credit	5.6	17.1	12.0	14.2	3.5	14.7
Percentage Increase in Total Assets and Liabilities	3.0	17.7	16.6	17.0	15.0	19.8
Government as a percentage of Total Domestic Credit Increase	1.0	17.5	18.1	2.9	-137.0	6.0
Non-Government as a percentage of Total Domestic Credit Increase	99.0	82.5	81.9	97.1	237.0	94.0
Percentage Increase in:						
Broad Money Supply (M_2)	12.4	19.1	23.2	16.6	23.5	19.6
Narrow Money Supply (M_1)	9.1	12.8	18.0	7.3	19.0	19.0

Source : Central Bank of Sri Lanka

million) during the year compared to a growth of 87.9 per cent (Rs.21,238 million) in 1993. NFA of the Central Bank rose by Rs.14,288 million, while those of commercial banks expanded by Rs.2,814 million.

In the context of a sustained increase in deposit liabilities, the commercial banking system continued to remain liquid during 1994. Liquid assets of commercial banks increased by 18.5 per cent (Rs.12,204 million) in 1994 compared to a rise of 23.4 per cent (Rs.12,504 million) in the previous year. The expansion in liquid assets was mainly through increases in foreign balances, cash on hand, and investments in Treasury bills. Reflecting a slower increase in liquid assets in relation to deposit liabilities during the year, the ratio of liquid assets to demand deposits dropped from 190.8 per cent at the end of 1993 to 187.4 per cent at the end of 1994, while the ratio of liquid assets to total deposits fell marginally from 40.6 per cent to 40.2 per cent.

The total assets/liabilities of commercial banks (excluding contra items) expanded by 15 per cent (Rs.37,162 million) during the year, in comparison to a higher increase of 32 per cent (Rs.59,397 million) in the previous year. There were also some structural changes in assets and liabilities of commercial banks. The share of liquid assets in total assets rose from 27.0 per cent in 1993 to 27.8 per cent in 1994. The shares of foreign assets and investments in government securities and other instruments also rose from 8.4 per cent and 8.0 per cent in 1993, to 9.5 per cent and 9.3 per cent, respectively in 1994. The share of fixed assets declined from 21 per cent in 1993 to 17.9 per cent in 1994 while the share of total loans and advances remained unchanged at 51 per cent. On the liabilities side, the share of demand deposits increased from 14.2 per cent to 14.8 per cent while time and savings deposits rose from 51.1 per cent to 53 per cent of total liabilities. While the share of paid up capital in total liabilities rose by 1 percentage point to 10 per cent, the share of other liabilities declined from 21.1 per cent to 17.6 per cent.

Monetary Policy

In the context of a sustained high growth in monetary aggregates, the Central Bank was compelled to pursue a tight monetary policy stance during 1994, although the Bank's ability to conduct aggressive open market operations was hampered by a depleted stock of Treasury bills in its portfolio. Because of the limited scope for conducting open market operations through Treasury bills, the Central Bank issued its own securities with 3-6 month maturity to mop up excess liquidity. Consequently, the outstanding liabilities on account of Central Bank Securities rose from Rs.2,155 million at the end of 1993 to Rs.3,740 million at the end of 1994. The continued open market operations also enabled the Central Bank to reduce its holdings of Treasury bills from a level of Rs.3,949 million at the end of 1993, to Rs.31 million at the end of September. However, the Central Bank's holdings of Treasury bills increased in December 1994 to Rs.5,093 million.

As a further means of restraining the growth of reserve money, the Central Bank terminated its short term refinance facility. The refinance facility under the New Comprehensive Rural Credit Scheme (NCRCS) was terminated with effect from 31 March 1994. However, arrangements were made to provide an interest subsidy by the Government to the lending institutions participating in the NCRCS in respect of agricultural credit extended under the Scheme. Export credit refinance facilities provided in respect of pre-shipment credit provided by commercial banks were terminated with effect from 31st May 1994. Consequent to these changes, short term refinance provided by the Central Bank declined from Rs.753 million at the end of December 1993 to Rs.72 million at the end of December 1994.

The Central Bank also refrained from granting new credit under the Medium and Long Term Credit Fund (MLCF) although requests for refinance from distressed finance companies continued to be accommodated, the amount of funds provided however being curtailed. A sum of Rs.263 million was granted in 1994 for this purpose while Rs.4 million was received as repayments. Consequently, the outstanding level of refinance facilities granted to distressed finance companies under the MLCF rose from Rs.2,045 million at the end of 1993 to Rs.2,304 million at the end of 1994. All in all, these measures brought down the overall outstanding refinance under both short term facilities and the MLCF from Rs.4,903 million at the end of 1993, to Rs.3,376 million at the end of 1994, a decrease of Rs.1,256 million, net of an increase in provisions for loan losses of Rs.271 million.

In order to contain the expansion of domestic credit, the Central Bank maintained the Statutory Reserve Ratio (SRR) on deposit liabilities at a high level of 15 per cent. However, with a view to encouraging commercial banks to build up their foreign currency assets, thus reducing the pressure on reserve money growth, the SRR on foreign currency deposits placed abroad was lowered to 5 per cent with effect from 18 February 1994. The continuation of a high statutory reserve ratio was conducive to reducing the money multiplier from 2.86 in December 1993 to 2.84 in December 1994.

Movements in Interest Rates

A significant variation in foreign inflows, changes in government fiscal operations and a rapid depletion of Treasury bills in the Central Bank's portfolio resulted in a considerable degree of volatility in interest rates during the year. The surge in foreign capital inflows experienced in 1993 continued into the early part of 1994, generating considerable liquidity in the domestic money market. With a limited holding of Treasury bills in its portfolio, the ability of the Central Bank to engage in open market operations to absorb excess liquidity was seriously constrained. Thus, despite the net issue of the Central Bank's own securities worth Rs.635 million and a reduction in Treasury bills held by Central Bank by Rs.3,908 million by end February 1994, the excess liquidity in the market led to a drop in the average yields on Treasury bills. Consequently, the average yield on 3-month Treasury bills dipped to 14.43 per cent by the end of February 1994 from 18.09 at the beginning of the year, while the 6-month Treasury bill rate fell to 14.88 per cent from 18.47 per cent and the 12-month rate fell to 15.63 per cent from 19.38 per cent. These represented a drop of about 3.75 percentage points in the average yield of Treasury bills within a period of two months.

This fall in interest rates continued into the middle of March. However, the new issue of Rs.1,400 million worth of Treasury bills in March 1994 and the issue of Rs.686 million worth of Central Bank Securities in March served to arrest this downward trend. Further new issues of Rs.600 million of Treasury bills in April and Central Bank Securities worth Rs.470 million in May were conducive to sustaining the upward trend in interest rates. Consequently, by the end of June, the average yield rate on 3-month Treasury bills rose to 15.39 per cent, while the yield on 6-month and 12-month bills had risen to 15.62 per cent and 15.87 per cent, respectively.

Increased liquidity conditions witnessed during July led to a downward movement in interest rates in subsequent months. Depleted stocks of Treasury bills in the Central Bank and the non-renewal of maturing short-term Central Bank Securities caused the yield on 3-month Treasury bills to decline to 11.58 per cent and 12-month bill rate to 12.20 per cent by October 1994. The last two months of the year witnessed a drastic reversal of this trend, following the slowing down of foreign capital inflows and fresh demand for Treasury bills to the tune of Rs.3,000 million from the Government to meet its cash needs in December 1994. During the last quarter of 1994, the Central Bank was compelled to intensify its open market operations to dampen the high rate of growth of monetary aggregates through the issue of Rs.2,510 million of its own Securities. These factors saw a steep rise in interest rates in December 1994. By the end of December, the yield on 3-month

Treasury bills rose to 18.73 per cent, while the 6-month and 12-month rates rose to 19.29 per cent and 19.43 per cent, respectively. However, in spite of the sharp rise in the yield on Treasury bills, the Central Bank's holdings of Treasury bills increased from Rs.1,433 million at the end of October, to Rs.5,093 million at the end of December, fuelling reserve money expansion. The most noteworthy development in the Treasury bill market during 1994 was the over subscription at Primary Treasury bill auctions on most occasions.

Meanwhile, the repurchase market introduced by the Central Bank in October 1993, partly to prevent excessive declines in inter-bank call money market rates, succeeded, in general, in preventing drastic declines in rates. However, at certain times when the portfolio of bills held by the Central Bank was exhausted, significant drops in the call money rates were observed. Call market rates which were in the range of 16.50-18.50 per cent at the end of December 1993, had declined, but to a wider range of 05.00-15.00 per cent, by the end of March. The Central Bank's overnight repurchase yield rate had also been gradually reduced from 16.5 per cent at the end of 1993 to 12.00 per cent by the end of March, in line with market developments. The overnight repurchase rate was maintained at this level, with minor variations, until mid-September. Call money rates at this time were at very low levels and hence the overnight repurchase rate was further decreased in steps to 7.00 per cent by mid-October. Call market rates were in the range of 04.00-08.00 per cent in the middle of September, but rose gradually to a range of 12.25-13.50 per cent by the end of October. The lack of market liquidity in the last two months of the year was also reflected in the call money market with rates rising to a range of 13.00-17.00 per cent at the end of November and to 20.00-23.00 per cent at the end of December. The Central Bank's overnight repurchase rate was also raised, reaching 13.75 per cent at the end of November and 20.00 per cent at the end of December.

The interest rates offered on National Savings Bank (NSB) savings deposits remained at 14.00 per cent throughout the year. Rates on fixed deposits, which were in the range of 16.00-17.00 per cent, were maintained at this level until December, when they were reduced to 14.00 per cent. The deposit rates of commercial banks, which declined towards the end of 1993, continued to decline in 1994. The interest rates on time deposits of commercial banks varied in a range of 8.00-18.25 per cent at the end of 1994 compared to 10.00-19.00 per cent at the end of 1993, while those on savings deposits remained in a range of 5.5-13.0 per cent as against 6.0-15.0 per cent in 1993. Underscoring these developments, the Average Weighted Deposit Rate (AWDR) fell from 13.6 per cent at the end of December 1993 to 12.6 per cent at the end of December 1994. Consequently, the Average Weighted Prime Lending Rate (AWPR) of commercial banks also declined from 20.4 per cent at the end of 1993 to 16.9 per cent at the end of October 1994 but rose to 17.8 per cent by the end of the year in line with the upturn in Treasury bill yield rates. Meanwhile, long term rates were in general lower during 1994 than in 1993, following the general downward trend in short term rates. The interest rates for government securities with 3-5 year maturities were 14.0-16.0 per cent, compared to 16.0-17.0 per cent in 1993. Longer term rupee securities with maturity periods of 6 and 7 years were also floated during this period carrying interest rates in the range of 14.00-15.75 per cent.

Problems and Policies

There was further progress made on the ongoing liberalisation of exchange and trade restrictions in 1994. The complete removal of exchange restrictions on current international transactions in March 1994 with the acceptance of Article VIII obligations of the International Monetary Fund was a landmark in the continued progress made in recent years towards the liberalisation of exchange controls and full convertibility of the Sri Lanka Rupee. With the acceptance of Article VIII obligations, the Sri Lanka Rupee became freely convertible in respect of all current international transactions. Acceding to Article VIII status would make it obligatory for the Government to pursue sound economic policies that will obviate the need to use restrictions on payments and transfers for current international transactions. Import licensing requirements in respect of most of the remaining items under controls were also removed in 1994. By and large, Sri Lanka's import controls are now confined to a limited range of items - those essential for health, security and environmental reasons.

Meanwhile, structural reforms in other areas suffered a set back in the backdrop of two national elections in 1994. There was little progress in tax reforms, privatisation and financial sector reforms during the year. The progress made towards rationalizing turnover taxes in recent years to facilitate a smooth transition to a Goods and Services Tax (GST) was set back to some extent by the grant of exemptions or reductions in the tax rates for a wide range of items during the year.

Significant slippages were observed in respect of customs tariff reforms. Although customs tariffs were rationalized in November 1993 within a four-band rate structure of 10, 20, 35 and 45 per cent, the grant of duty waivers and exemptions and the creation of a 5 per cent rate band seriously complicated the new tariff schedule. Apart from a substantial loss in government revenue, some of these changes resulted in considerable distortions in effective protection, which was to be uniformly extended. The complete exemption of items such as lentils from customs duty compelled domestic agricultural producers of similar products to compete at international prices. Similarly, the reductions and exemptions from customs duty on various raw materials and parts, while maintaining a high tariff on finished products, meant that the tariff system provided no protection to domestically produced raw materials and components, thus undermining the incentive structure for backward linkages in industrial development.

There was also some relaxation in the policy stance in respect of public sector employment. Although a freeze on the filling of vacancies and a rationalisation of existing cadre positions have been the explicit policy strategy in public sector reforms in recent years, in the midst of national elections, the Government decided to provide employment to 8,000 graduates and grant permanency to all casual employees in the public service. These decisions undermined the rationalization effort with regard to public sector employment. The Government also decided to grant a substantial salary increase to all school teachers although the financial cost of these decisions will be felt in the future Budgets.

A reversal in the policy strategy with regard to the targeting of welfare expenditure was also seen in 1994. The decision to limit the School Mid-Day Meal Programme to families receiving food stamps was reversed in May 1994. Consequently, the annual cost of this programme increased to Rs.2,300 million from the budgetary target of Rs.900 million. The implementation of the 5th round of the Janasaviya Programme which was scheduled for the end of 1994, was advanced and an income transfer was provided to all the families who came under the 5th round without proper targeting.

The policy stance with respect to administered prices also changed in the course of the year. The electricity tariff revisions in recent years aimed at generating an adequate rate of return on investment in the power sector suffered a reversal with the decision to reduce the increased tariffs. The price of wheat flour which was brought in line with cost over many years of administrative price corrections, was reduced by Rs.1.50 per kg in July 1994 and again by Rs.4.35 per kg in late August 1994 with adverse consequences on the Budget as well as on producer prices of domestic substitutes such as rice. There was also a reduction in the administered prices of kerosene and diesel which further distorted the price structure of petroleum products. These distortions led to an increase in the consumption of diesel which is now growing at around 10 per cent per year owing to the relative price advantage of diesel. This has implications not only for the government budget but also for the country's imports. In the face of high international prices for fertilizer, an across the board subsidy of 30 per cent on fertilizer was introduced in October 1994. Apart from causing considerable price distortions in domestic food prices, the subsidies on wheat flour, bread and fertilizer are estimated to cost about 1 per cent of GDP in 1995 compounding the difficulties in making fiscal adjustments.

The foregoing account shows that there were significant slippages in structural reforms in 1994. The continued implementation of economic reforms tended to be overlooked in favour of short term populist policies. Admittedly, these measures led to some short term benefits to the consumer. However, whether such measures can improve income and employment opportunities and ultimately maintain high economic growth and the well being of the people on a sustainable basis is a matter that requires careful analysis. The provision of various relief measures through reductions in administered prices, tax exemptions and direct budgetary grants would lead to an increasing budget deficit. Apart from the budgetary cost, which would ultimately necessitate high taxes on the remaining tax base or would result in high inflation and high interest rates, such measures discourage production and exports and encourage consumption and imports with the consequent reduction in employment and overall well being of the people.

The prime aim of economic policy reforms is to achieve rapid economic growth on a sustainable basis. Evidence from high performing Asian economies suggests that rapid growth compatible with distributional objectives and the well being of the people can be achieved through the adoption of correct economic polices. The rapid progress in high performing economies and recent research on the subject have made it clear that there is no inevitable trade-off between growth and equity and that what happens to poverty during growth is determined in a large measure by policy. The question facing economic policy, therefore, is not the trade-off between growth and equity, but how to ensure that growth reduces poverty and inequality in income. A broad consensus is emerging today that broad-based sustainable economic growth that generates employment is the key to a rapid reduction in poverty and income inequality. The essential characteristics of such a growth strategy include prudent macro economic policies, outward oriented production, increased private sector participation, flexible labour markets, an efficient financial system and a strong infrastructure base.

Economic growth has to be supported by a stable macro economic environment and policies to enhance supply conditions. A stable macro economic environment which improves predictability in economic decisions in a market oriented policy framework is a necessary pre-condition to encourage savings and investment. Instability in macro economic conditions, besides its adverse distributional effects through a high rate of inflation, directly reduces economic growth as uncertainty reduces the efficiency of resource allocation, lowers investment and thus reduces the rate of productivity growth. Structural adjustments are necessary to remove various impediments to the efficient functioning of the market mechanism and create a private sector friendly economic environment. Such adjustments will strengthen the supply response of the economy and the efficiency of resource allocation as adjustments are meant to address various constraints such as trade barriers, production bottlenecks, limits in property rights, predominant public ownership in commercial enterprises, infrastructure deficiencies and institutional rigidities. The thrust of structural adjustment therefore is to create conditions conducive to rapid economic growth led by market principles.

Price stability is a prime objective of macro economic policy. As highlighted in the previous year's annual report, a persistently high inflationary pressure in Sri Lanka in recent years was due to *(a)* high budget deficits, *(b)* sustained increase in money supply, *(c)* low productivity, and *(d)* the resulting inflationary expectations. Fiscal imbalances in Sri Lanka have remained excessively above the desired level for macro economic stability. The current account of the budget has been in deficit for several years in the recent past reflecting a high consumption orientation in government fiscal operations. The budget deficit averaged nearly 10.0 per cent of GDP during the 1989 - 1994 period and domestic borrowings remained around 5.0 per cent of GDP. Deficit financing by creating domestic debt has resulted in a high debt burden on the budget. High domestic borrowing by the Government is one of the major factors affecting the prevailing high interest rate structure in the country. Heavy reliance on domestic borrowings by the Government has pre-empted resources otherwise available to the private sector, constraining the full exploitation of the country's growth potential. In the context of large capital inflows stimulated by economic reforms and very high credit needs of the emerging private sector, high budget deficits frustrate the monetary policy effort to contain liquidity at levels consistent with price stability.

Pursuance of prudent macro economic policies in Sri Lanka requires strong fiscal action to reduce budget deficits. Although such action consists of revenue augmenting measures and expenditure restraint policies in the short run, far reaching structural reforms in the government budget are necessary to find a durable solution to the country's emerging macro economic problems. In spite of a generally high revenue effort, the Government has not been able to maintain an elastic revenue structure in recent years due to the grant of various tax concessions, exemptions and ad hoc waivers which have resulted in a considerable erosion in the tax base. Many complexities in the tax system have also not been helpful for the improvement in tax administration. The systematic decline in the revenue/GDP ratio from 21.4 per cent in 1989 to 19.0 per cent in 1994 underscored these weaknesses in the country's revenue system. It is, therefore, necessary to pursue policy reforms towards a simple broad based tax structure which will improve the built in elasticity in revenue, ensure high compliance and facilitate tax administration.

The current structure of government expenditure is more worrisome. Expenditure on salaries and pensions accounts for a third of current expenditure. Apart from salary increases, the expenditure on government salaries has increased due to the continued expansion in public sector employment. While the salary structure for managerial categories has become completely out of line with that of other categories which received substantial salary increases under the recent reforms, wage costs have risen due to the bottom heavy nature of public service. Meanwhile, the cost of government pensions and retirement benefits has increased three-fold between 1990 and 1994, in the context of increased life expectancy and a large number of retirees each year. In this regard, it is important to focus on public sector employment policies and pension schemes so as to reduce the burden on the government budget.

Another area of concern in fiscal reforms is welfare expenditure, which accounts for about 22 per cent of current expenditure. Apart from the high cost in the budget, a rationalisation of welfare expenditure within a single well targetted welfare programme is necessary to make the desired impact on income redistribution. Provision of welfare to all citizens in the country will lead to a waste of resources on those who do not require welfare measures. Moreover, a single well targetted welfare programme will enable the Government to provide enhanced income transfers to the needy within the same budgetary constraint. A single income transfer scheme will also obviate the need for universal subsidisation through price adjustments.

Sri Lanka has made considerable headway in its trade reforms to increase exports and boost viable import substitution industries. On going tariff reforms and the removal of licensing requirements on exports and imports have encouraged increased investment in export oriented and domestic industries. However, the same cannot be said of the agricultural sector which have not been liberalised. The removal of licensing requirements and the use of an appropriate tariff structure to create the necessary protection and incentive structure is vital for the exploitation of the full potential in domestic agriculture. At present, the tariff structure is very distortionary. A number of agricultural items such as wheat flour and lentils are not subject to import duties, thus making their relative prices disadvantageous to domestic production of substitutes. The relative prices in agriculture have also been distorted by the recently introduced wheat flour subsidy which has shifted consumer preferences away from domestic products. The correction of these distortions and the restoring of correct price signals, although affecting the cost of living in the short run, particularly in the urban areas, will have to be made in the interests of promoting food production in the country. Economic reforms to achieve rapid economic growth and alleviate poverty must tackle the problem of low productivity in domestic agriculture as the majority of Sri Lanka's poor resides in rural areas and are predominantly engaged in farm activities. The infusion of capital, technology and modern methods of farming to these areas and the expansion of the marketing network are necessary to raise productivity in domestic agriculture.

Private sector participation in productive activities in agriculture, industry and services have been constrained by the prevailing policies on land use, inflexible labour market conditions, government ownership of large public enterprises particularly in the areas of infrastructure and services, inadequate infrastructure facilities and excessive borrowings by the Government from institutional investors such as the Employees' Provident Fund. In the context of the emerging economic environment where property rights are an important element in long term investment, it is necessary to review the present land policies which restrict ownership, with a view to introducing some flexibility to promote private sector investment in domestic and plantation agriculture.

Flexibility in labour markets makes a significant contribution towards promoting economic growth that will generate employment. The labour markets in Sri Lanka suffer from several weaknesses. First, they are segmented, resulting in an inefficient allocation of resources and generating pressure on public sector employment. Second, wages, employment and working conditions are largely determined by government legislation and under union pressure. This means that labour market conditions do not provide adequate flexibility in the determination of wages in relation to widespread unemployment. In this context, it is necessary to pursue policy reforms in respect of labour markets, providing flexibility to the employer-employee relationship. The focus on labour policy should be to ensure that fair labour legislation is applied uniformly, so that workers who need to look for new jobs are given adequate support enabling effective mobility of labour to take place.

The focus of economic reforms must also be directed at creating conditions conducive to releasing an enhanced volume of resources to the emerging private sector. At present, the flow of financial resources to this sector is constrained by high budget deficits which prevent the use of long term funds available with institutional investors such as the Employees' Provident Fund and pensions funds by the private sector. Large budget deficits have also compelled the implementation of a tight monetary policy. The adverse impact of high interest rates on private investment need not be over-emphasised. While fiscal adjustments towards lower budget deficits will provide considerable relief to private investment, it is also necessary to address the present institutional constraints which prevent institutional investors such as the Employees' Provident Fund investing in private sector ventures. Further restructuring of the two state banks with greater autonomy in commercial activity will also be necessary to improve the competitive environment in the banking system.

Sri Lanka's growth effort has been seriously constrained by infrastructure deficiencies. Public investment in vital infrastructure such as roads and highways, telecommunication, electricity, port services and water supply is around 4 per cent of GDP and is hardly adequate for a rapid expansion of such facilities to meet the growing demand. Demand for electricity, for example, is growing at around 10 per cent per annum at present, but the capacity has not increased during the last four years. Moreover, the utilisation of existing capacity largely depends on exogenous factors such as weather conditions making the power supply increasingly vulnerable to non-controllable factors. Public enterprises which manage these infrastructure facilities rely on budgetary support based on foreign aid and do not generate an adequate investible surplus to expand investment. Given the constraint in the budget to raise resources to meet infrastructure needs, these enterprises will have to seek private sector support in addition to following appropriate pricing policies to recover costs.

The inevitable conclusions of the foregoing discussion is that Sri Lanka has to follow a strong fiscal adjustment programme together with structural reforms on a wider front to sustain high economic growth that will create employment and reduce poverty in the period ahead. The new Government's commitment to reduce the budget deficit within a three year medium term time frame to a level of 5 per cent of GDP in 1997 - one half of the 1994 budget deficit and to pursue structural reforms to remove constraints to rapid economic growth are steps in the right direction towards achieving these goals.