1. ECONOMIC PERFORMANCE, PROBLEMS AND POLICIES IN 1995

1.1 Overview

A moderately high economic growth, lower inflation, a significant reduction in the fiscal imbalance and re-emergence of an overall deficit in the balance of payments were the salient features of the Sri Lankan economy in 1995. The Government's commitment to a medium-term framework for correcting structural weaknesses and reducing the budget deficit, consistent with faster growth, price stability and external viability, was reaffirmed in the 1995 Budget and other policy statements. Significant progress was made in 1995 towards this goal, particularly in the areas of tariff reform and privatisation. There was also a notable reduction in the current account and overall deficits on fiscal operations compared to their 1994 levels. However, the achievements on the fiscal front were below the 1995 budgetary targets. Rising defence expenditures made heavy claims on budgetary resources. With the high international wheat prices, the wheat flour subsidy became a greater budgetary burden, in addition to its adverse effects on resource allocation and domestic agriculture. Despite revenue enhancing and expenditure rationalisation measures introduced during 1995, there were structural weaknesses due to high and inflexible costs arising from salaries and wages and pension payments in the public sector and interest costs of public debt. These constrained fiscal adjustments in the short-run. Thus, it was not possible to achieve the current account surplus and the net repayment to the banking system by the Government envisaged in the 1995 Budget. The fiscal operations became expansionary, contributing significantly to the persistently high monetary growth.

On the external front, exports performed well, but a considerable slowing down of capital inflows led to an overall deficit in the balance of payments and a faster depreciation of the exchange rate. Meanwhile, increased real incomes and positive real interest rates, coupled with aggressive savings mobilisation efforts by banks, raised domestic savings. However, private investment was at a low ebb due to uncertainties regarding the domestic security situation, increased labour unrest and the spillover effects of world capital and exchange market volatility in the aftermath of the Mexican crisis.

1.2 Real Sector Developments

Economic Growth

The Sri Lanka economy grew by 5.5 per cent in 1995, as indicated by the real growth of the Gross Domestic Product (GDP), thus maintaining the growth momentum observed during the last few years with progressive economic liberalisation. This moderately high growth was supported by continuity in reforms towards consolidating a market friendly economic policy environment, a strong export performance, an improvement in primary commodity prices and favourable weather conditions. The annual average growth rate during the previous five years was 5.5 per cent.

TABLE 1.1
National Income Statistics 1993 - 1995

Item	Amount Rs. Million			Growth Rate Percentage	
	1993*	1994*	1995*	1994*	1995*
1. GDP at Current Factor Cost Prices	453,092	523,300	598,327	15.5	14.3
2. GDP at Constant (1982) Factor Cost Prices	150,783	159,269	167,953	5.6	5.5
3. GNP at Current Factor Cost Prices	447,113	514,990	591,245	15.2	14.8
4 GNP at Constant (1982) Factor Cost Prices	148,744	156,571	165,860	5.3	5.9
5. GNP at Current Market Prices	499,622	575,528	658,503	15.2	14.4
6. GDP at Current Market Prices	499,760	579,147	661,902	5.9	14.3
7. Mid Year Population ('000)	17,619	17,865	18,112	1.4	1.4
8. GNP per Capita					
At Current Factor Cost Prices (Rs.)	25,377	28,827	32,644	13.6	13.2
At Constant Factor Cost Prices (Rs.)	8,442	8,764	9,157	3.8	4.5
At Current Market Prices (Rs.)	28,357	32,215	36,357	13.6	12.9
9. GDP per Capita at Current Market Prices	28,365	32,418	36,545	14.3	12.7

* Provisional.

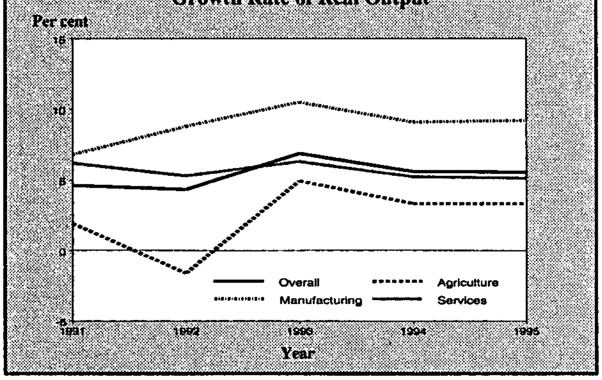
Source: Central Bank of Sri Lanka

With a nominal GDP growth rate of 14 per cent, Sri Lanka's per capita income reached Rs.36,545 (US dollars 713) as compared with Rs.32,418 (US dollars 656) in 1994. This level of per capita income, though the highest among South Asian countries, is far behind that of industrial nations and the fast growing Asian countries. Five decades ago Sri Lanka was amongst the relatively high income countries of Asia, but has since fallen behind in terms of economic performance. Although the recent economic growth has been encouraging, a higher performance is called for to keep pace with economic expansion in the rest of the world. It should be noted, however, that the recent growth performance has been achieved despite a lingering armed conflict in a part of the country.

When the GDP is adjusted for investment income outflows, the Gross National Product (GNP) rose by 5.9 per cent in 1995. When this is adjusted for the population growth of 1.4 per cent, the per capita real income rose by 4.5 per cent in 1995.

The Manufacturing sector spearheaded economic growth in 1995 with a contribution of 31 per cent. The other major contributing sectors were Trade with 13 per cent, Agriculture with 12 per cent, Transport and communication with 11 per cent and Financial services with 10 per cent. The fastest growing sectors were Financial services (11 per cent), Electricity, gas and water (10 per cent) and Manufacturing (9 per cent). The Agriculture sector recorded a modest increase of 3 per cent.

Chart 1.1
Growth Rate of Real Output



The Sri Lanka economy, which was once dominated by agriculture, has continued to show signs of growing diversification. Whereas the Wholesale and retail trade sector barely remains as the lead sector with a 22 per cent share of GNP, the Manufacturing sector, with a 21 per cent share, has overtaken the Agriculture sector, with a 20 per cent share, for the first time.

Agriculture

The Agriculture sector as a whole, including forestry and fishing, registered a growth rate of 3.3 per cent in real terms, almost the same rate as in the previous year, while other sectors combined grew by 6 per cent. In the early 1960s the share of agriculture in GDP was around 40 per cent. It declined to 23 per cent by 1990 and further to 20 per cent in 1994. The Agriculture sector's contribution to economic growth declined from 13 per cent in 1994 to 11 per cent in 1995.

Sri Lanka's plantation industry, once pre-eminent in the economy, has been experiencing intermittent crises over a very long period. The problems related to high wage costs, low yield and low productivity became accentuated after the State assumed ownership following land reforms. Direct involvement by the State in the management of plantations for socio-political considerations received priority over commercial considerations. Hence, the management of the plantations by the Janatha Estates Development Board (JEDB) and the Sri Lanka State Plantations Corporation (SLSPC) was characterised by large financial losses, increasing costs and a decline in efficiency. As a remedial measure, the Government in 1992 decided on a restructuring programme, when the majority of state plantations was handed over to private management companies on a five year contract basis. However, due to the short-term nature of this contractual arrangement, there was little incentive for the private managers to undertake new investments and improvements which would yield results over the longer-term. Hence, the Government in 1995 decided to privatise the management of the state plantations for a 50 year period, with options to renew the leases.

In 1995, value added in tea, rubber and coconut production has increased by 1.6 per cent, 0.9 per cent and 5.1 per cent, respectively. Tea prices at the Colombo Auctions rose from Rs.65.12 per kg to Rs.72.21 per kg in 1995 in line with a 12 per cent increase in export prices. This reflected increased global demand for tea, particularly the recovery of demand in the Commonwealth of Independent States (the former Soviet Union) and a reduction in the exportable surplus of tea in India due to increased domestic consumption. Tea production in 1995 surpassed the peak production of the previous year by 2 per cent to reach 246 million kg. This was due largely to favourable weather conditions. Improved management of state plantations, high productivity among smallholders and attractive prices also contributed to this increase.

The rubber sector experienced boom prices in 1995 owing to a recovery of global demand for natural rubber and a drop in world rubber stocks. However, Sri Lanka's producers were unable to benefit fully because production remained virtually static on account of continuing problems in the sector arising from depressed prices over a long period. The sector also experienced continuing problems due to labour shortages. Rubber has been predominantly a smallholder crop with over 60 per cent of the extent under tapping being in the hands of the private sector. The average cost of production in the smallholder sector increased by 6 per cent. In the larger plantations it rose by 32 per cent, mainly reflecting higher labour costs and high fertiliser and other input costs. The improved prices in 1995, however, provided some incentive for replanting with better varieties. However, the lack of dynamism in the rubber sector is evident from the disappointing performance of the Small Holder Rubber Rehabilitation Programme under which the success rate so far has been only 50 per cent. Meanwhile, domestic consumption of rubber has been rising, reflecting the growth of domestic rubber based industries.

Coconut output surpassed the previous year's production by 5 per cent, registering the highest crop since 1986, following a growth of 21 per cent in 1994. The growth in production was attributed to the lagged effect of the favourable weather conditions that prevailed in the previous two years and increased application of fertiliser. The average yield increased by 5 per cent. Due to increased supply, the average domestic price of coconuts, which form an important part of the daily diet of Sri Lankans, declined moderately in 1995. As in the case of other crops, the cost of production increased, by 7 per cent to Rs.1.97 per nut in 1995, due to wage increases and higher fertiliser prices. The area under coconut increased, despite coconut land near urban areas being converted to residential areas. Meanwhile, during the year, there has been a significant increase in land under coconut for replanting and inter-cropping.

The rest of the export crops sector experienced mixed fortunes, with the output of cinnamon, citronella, nutmeg and mace recording increases, and coffee, pepper, cloves and cardamoms reflecting decreases.

Meanwhile, the domestic market oriented agricultural sector performed well during the year. Paddy production rose by 5 per cent owing to favourable weather conditions and increased use of fertiliser, and despite the availability of cheap subsidised wheat flour. The Maha 1994/95 harvest was estimated at 1.76 million metric tons, and exceeded the previous Maha production by 5 per cent. The Yala 1995 harvest increased by 3 per cent to 1.05 million metric tons. The increase was attributed to the higher extent harvested and an improvement in the yield. The average yield in 1995 registered a 5 per cent improvement to 3,535 kg per hectare, attributed largely to a 17 per cent increase in fertiliser use and liberal availability of credit. Agricultural loans granted

Chart 1.2
Sectoral Composition of GDP

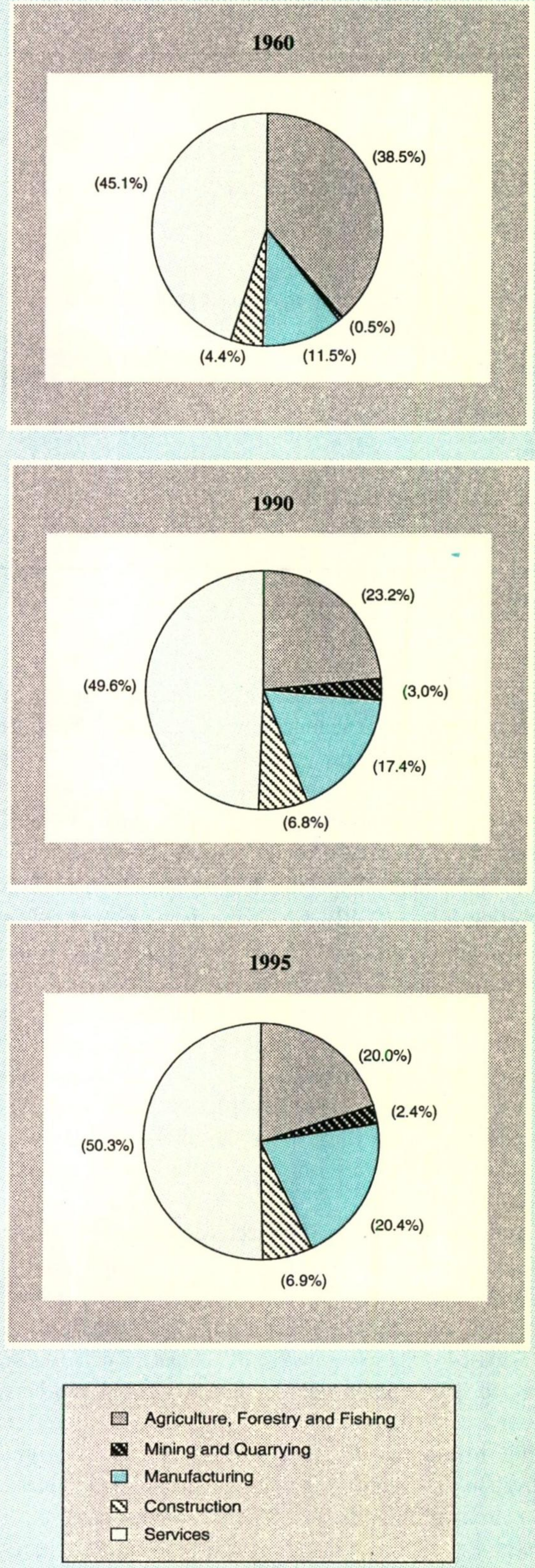


TABLE 1.2

Composition and Growth Rate of GNP 1993 - 1995 at Constant (1982) Factor Cost Prices

Item	Amount Rs. Million			Growth Rate Percentage	
	1993*	1994*	1995*	1994*	1995*
1 Agriculture, Forestry and Fishing	31,554	32,593	33,659	3.3	3.3
Tea	2,985	3,116	3,166	4.4	1.6
Rubber	681	688	694	1.0	0.9
Coconut	2,799	3,376	3,548	20.6	5.1
Paddy	6,447	6,750	7,067	4.7	4.7
Other Agriculture, Forestry and Fishing	18,642	18,663	19,184	0.1	2.8
2. Mining and Quarrying	3,693	3,915	4,048	6.0	3.4
3. Manufacturing	28,806	31,418	34,294	9.1	9.2
Processing of Tea, Rubber and Coconut Kernel Products	3,157	3,567	3,724	13.0	4.4
Other	25,649	27,851	30,570	8.6	9.8
4. Construction	10,400	11,024	11,564	6.0	4.9
5. Services	76,330	80,319	84,388	5.2	5.1
6. GDP	150,783	159,269	167,953	5.6	5.5
7. Net Factor Income from Abroad	-2,039	-2,698	-2,093	-	-
8. GNP	148,744	156,571	165,860	5.3	5.9

* Provisional.

Source: Central Bank of Sri Lanka

during Maha 1994/95 increased by 26 per cent over the previous Maha season. Similarly, credit extended during Yala 1995 also rose by 14 per cent.

When open market prices of paddy tended to decline on account of the record paddy crop and the availability of subsidised wheat flour, the Government owned Paddy Marketing Board (PMB), which was being phased out, was reactivated to procure farmers' output at the official procurement prices, with credit facilities from the banking system . The PMB purchased 282,000 metric tons of paddy in 1995 as against 120,000 in 1994. The purchases in 1995 accounted for about 10 per cent of the total paddy output, and probably had a marginal impact on the market. Thus, the reduction of the wheat flour subsidy in late 1995 was a welcome change in restoring price incentives to farmers.

Sugar production in 1995 recorded a marginal decrease. Output of the food crops sector, which includes heterogeneous products such as chillies, onions, potatoes, maize and kurakkan, reflected a mixed performance during 1995. Based on crop estimates, the output of potatoes, soya bean and sesame improved significantly. The potato harvest is estimated to have increased by more than 40 per cent, owing to improved yield and increased area under cultivation. In contrast, big onion production is estimated to have dropped sharply in 1995. Problems faced by the farmers, especially in marketing their produce after the 1994 bumper crop, discouraged the cultivation of this crop.

Value added in fish increased by 4.9 per cent in 1995 mainly reflecting sea and aquaculture fish production and increased output of prawns.

Mining and Quarrying

Gem mining, which accounts for a major share of the Mining and quarrying sector, suffered a setback in 1995. However, other mining activities performed well. This sector as a whole grew by 3.4 per cent in 1995. Export earnings from precious and semi-precious stones declined by 7 per cent in SDR terms.

Manufacturing

On the supply side, the growth in GDP in 1995 emanated mainly from the growth of the Manufacturing sector, primarily factory industries. While the Manufacturing sector has directly benefited from the recent liberalisation measures, the dynamism of this sector has underpinned the growth process and helped the economy to be resilient in the face of domestic and external shocks. The real output of factory industries grew by 10 per cent in 1995 after a dip to 8.8 per cent in the previous year and contributed to 28 per cent of the growth in real GDP. This growth was seen in both domestic market and export market oriented activities. Supported by the growth in factory industries, the Manufacturing sector grew by 9 per cent and contributed to 31 per cent of the overall economic growth.

The textiles, wearing apparel and leather products category, growing by 14.8 per cent, and the food, beverages and tobacco category, growing by 10.9 per cent, contributed to 79 per cent of the growth in industrial output. In 1995, the industrial output of the chemical, petroleum, rubber and plastic products category grew by 6.6 per cent, compared with an 9.1 per cent growth in 1994, the drop in the growth rate being attributed to the temporary closure of the petroleum refinery for routine maintenance. Private sector industrial output grew by 12 per cent in 1995 and accounted for 91 per cent of the total value added in industry.

On the policy front, the industrial sector was assisted through incentives provided under the liberalised policy setting and attractive tax concessions granted from time to time. With these and the gradual privatisation of state owned enterprises, the private sector has now become a dynamic force in industrial activity. The New Industrialisation Strategy announced in November 1995 emphasised the importance of a macroeconomic environment conducive to rapid industrialisation through rational economic management aimed at eliminating distortions in resource allocation and lowering inflation.

Medium and long-term credit under the Small and Medium-Scale Industries Credit Scheme (SMI), channelled through the National Development Bank (NDB), was continued in 1994. The scheme was co-funded by the Asian Development Bank (ADB) and the International Development Association (IDA). In addition, the Development Finance Corporation of Ceylon (DFCC), the NDB and commercial banks continued to provide direct financial facilities to industrial ventures in the form of loans and equity participation. However, resources available in the development financial institutions were almost fully committed by end 1995 and the two institutions negotiated new loans amounting to US dollars 58 million. Commercial bank credit to the industrial sector during the first nine months of the year increased by 25 per cent to Rs.24 billion at end September 1995 as compared with a 6 per cent growth during the first nine months of 1994.

Construction

The expansion of construction activities, a booming sector in the recent past, slowed down somewhat in 1995. While the drop in foreign capital inflows slowed down construction activities in the industrial and services sectors, a temporary shortage of cement as well as increased prices had an adverse impact, particularly on housing construction. Road construction activities continued, reflecting utilisation of increased allocation of funds by the Government.

Services

The Services sector, which includes Electricity, gas, water and sanitary services, Transport storage and communication, Wholesale and retail trade, Banking, insurance and real estate, Ownership of dwellings, Public administration and defence and all other services, has been one of the rapidly growing sectors in the recent past as generally experienced in fast growing economies. In 1995, this sector grew by 5 per cent and contributed to 44 per cent of the economic growth. The Wholesale and retail trade sector grew only by 3.6 per cent owing to higher value added in export and domestic market related trade being offset to some extent by a sharp drop in the growth of import related trading activities. The Electricity, gas, water and sanitary services sector grew by 10.2 per cent. Communication services grew by 14 per cent and was one of the more dynamic sectors of the economy. Port services grew by 7 per cent reflecting an increased volume of exports and trans-shipment cargo.

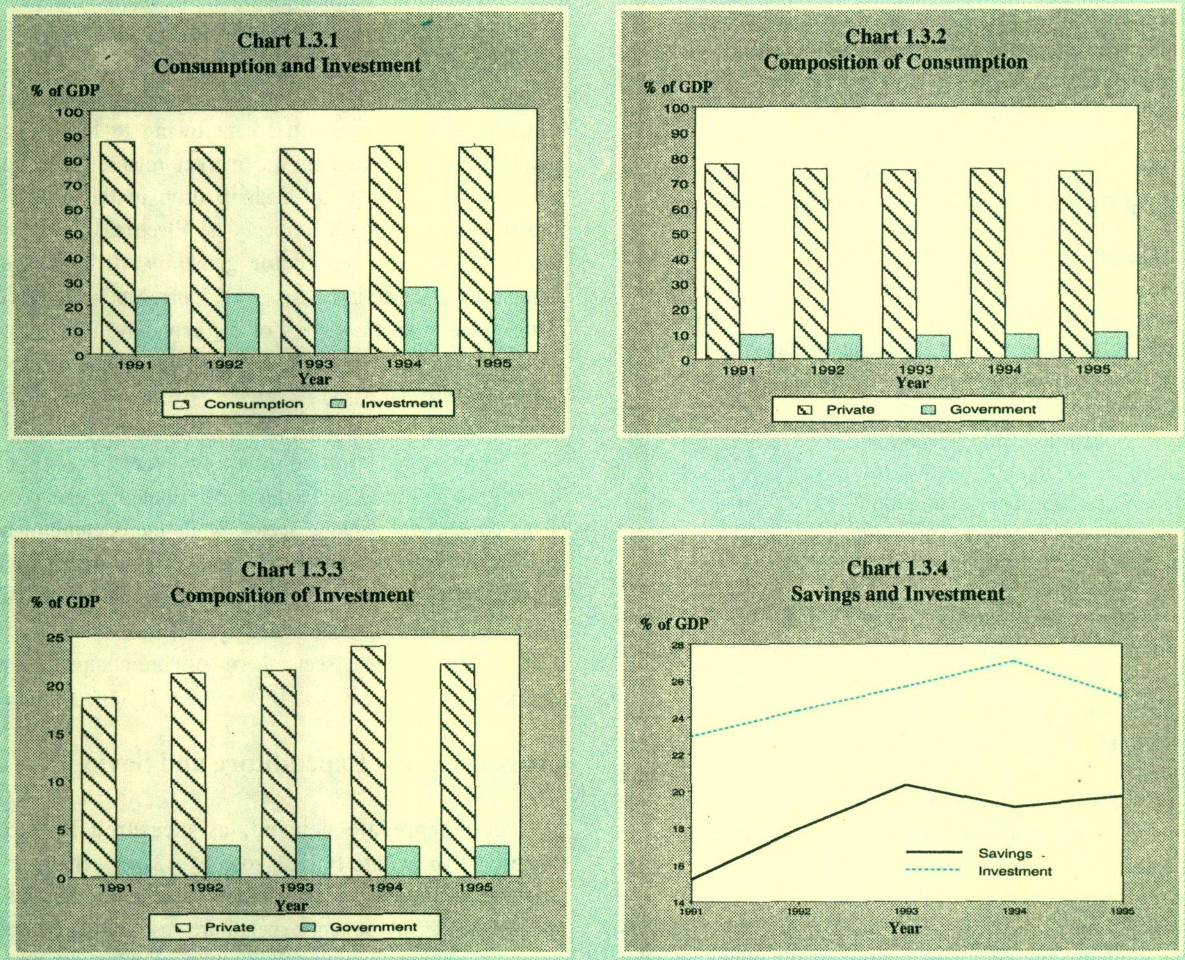
Further expansion of banking services with new instruments and modern facilities contributed to the growth of the commercial banking sector, while the opening of new commercial banks indicated a growing confidence in the financial system of Sri Lanka. With share market activities remaining depressed, value added by brokering firms dropped in 1995. The insurance sector became more competitive and dynamic in 1995.

Gross Domestic Expenditure and Savings

Total aggregate demand, as measured by Gross Domestic Expenditure (GDE), rose by 12 per cent in 1995 to Rs.725,710 million. Consumption expenditure rose by 14 per cent, while investment expenditure rose by 6.3 per cent. Private consumption expenditure grew at 12.7 per cent, a slightly lower rate than the growth in nominal incomes and as a result, its ratio to GDP dropped marginally. Government consumption expenditure rose during the year to 10.5 per cent of GDP, as compared with 9.7 per cent of GDP in 1994, reflecting increased expenditure on purchases of goods and services and on defence.

Meanwhile, investment demand decreased as a result of a slowing down of foreign private capital flows and a deterioration in the investment climate due to labour unrest, the uncertain security situation and a depressed domestic capital market. Foreign capital to Sri Lanka was partly affected by the exchange and capital market volatility following the Mexican crisis, as foreign investors shifted away from developing country capital markets. Private investment as a ratio of GDP, after excluding aircraft purchases by Air Lanka, dropped by 1.2 percentage points. This drop was largely attributed to lower foreign private capital inflows.

Chart 1.3
Aggregate Demand and Savings



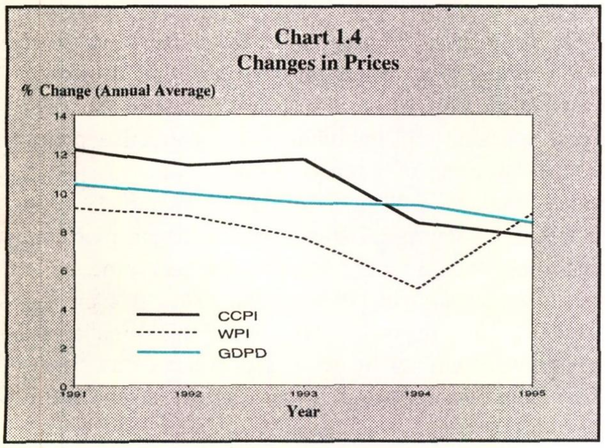
External demand remained strong in 1995. Exports of goods and non-factor services increased by 10 per cent in SDR terms, and as a ratio of GDP, rose to 36 per cent from 34 per cent in 1994.

Domestic savings in 1995 increased in nominal terms by 16 per cent. Domestic savings as a ratio of GDP, an aggregate indicator of the savings rate in the economy, rose to 15.5 per cent. The level of national savings, which was derived by adjusting domestic savings for private remittances and net foreign investment income outflows, rose to 19.7 per cent of GDP in 1995 from 19.1 per cent in 1994. It is important to note that private remittances amounting to 5.3 per cent of GDP raised the national savings rate significantly above the domestic savings rate. Therefore, the use of foreign savings to finance investment in 1995 was around 4.2 per cent of GDP.

Prices

In 1995, the moderately high rate of economic growth was achieved in an environment of lower inflation. The annual average inflation rate, as measured by the Colombo Consumers' Price Index (CCPI), dropped to 7.7 per cent in 1995. It is noteworthy that inflation has declined during the last five years from a peak of 21.5 per cent in 1990, and that 1995 was the second successive year to record a single digit increase in the index since 1987. The other available aggregate price indicators such as the Greater Colombo Consumers' Price Index and the Gross National Product Implicit Price Deflator also indicated a notable reduction in inflation. The drop in the annual average inflation rate was attributed to improved supplies of basic food items, reduction of import duties, an improved distribution network for consumer goods, particularly the dynamic trade policy followed by the public sector trading organisations in moderating seasonal fluctuations and the effect of the lowering of key administered prices of wheat flour, bread and kerosene in the latter part of 1994. The increase in the supply of some major agricultural commodities such as paddy, coconuts and onions as a result of favourable weather conditions and the importation of major food commodities during periods of shortage were other factors responsible for containing price increases during the year. Thus, there was only a moderate increase in prices instead of the high prices generally observed towards the end of the year. The gradual reduction of the wheat flour subsidy influenced the behaviour of prices during the second half of the year. At end 1995, the CCPI had increased by 11.5 per cent on a December to December basis, after a dip in 1994.

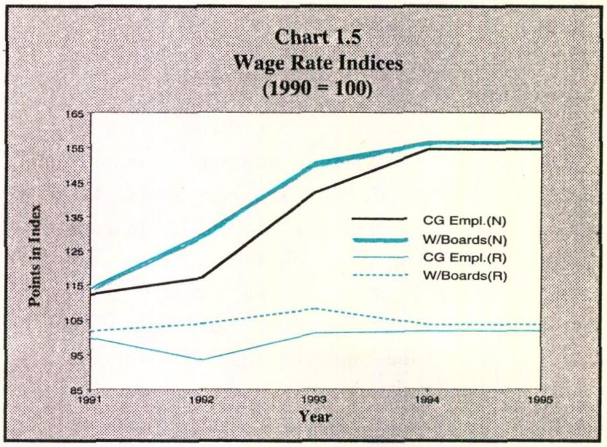
The behaviour of the CCPI during the year partly reflected the seasonal patterns. In line with the seasonality in agricultural production, the index declined during February-March (Maha harvest) and again during August-September (Yala harvest) in 1995. From September 1995 onwards, the index registered an increase due to the gradual factoring out of the effect of the previous year's administrative price reductions and the reduction of the wheat flour subsidy.



The Wholesale Price Index (WPI), which measures prices at the primary market level, indicated an acceleration in the rate of price increase to 8.9 per cent in 1995 from 5.0 per cent in 1994. This reflected the greater sensitivity of this index to price increases of major export and import commodities during the year. The point to point increase in the WPI at end 1995 was 17 per cent, following a drop in 1994.

Wages

Both government and private sector employees experienced significant wage increases in 1995. When the wage changes were deflated by the moderate inflation, workers in several sectors experienced a rise in real wages.



The salaries of several categories of employees were revised upwards during the year. In the organised private sector, many Wages Boards revised their minimum wages. In the informal sector, nominal wages of most activities such as building construction and smallholder cultivation rose faster than the rate of inflation, thus raising the real wages.

Salaries of government school teachers were raised substantially from 1 January 1995, which was considered an overdue adjustment. This was the most significant development in the wage structure of the public sector in 1995. There were upward revisions of the salary scales of many other grades from January. The interim allowances granted to services such as engineering, veterinary and agriculture were extended to other parallel managerial services from July and further adjustments were made in November 1995.

The revision of salary scales of government school teachers with the introduction of the Teachers' Service System raised their nominal wages by a substantial 27.7 per cent in 1995, resulting in a significant increase in real wages. Wages of non-executive officers grew by 8.2 per cent, while those of minor employees rose by 7.2 per cent in 1995.

Of the 34 active Wages Boards, 22 Boards raised minimum wages in trades covered by them with the objective of bringing the floor minimum wage upto Rs.2,000 per month. In addition to these developments, a total of 27 collective agreements were concluded in 1995 as compared to 20 in 1994.

The overall minimum wage rate index of workers in Wages Boards rose by 3.8 per cent. The increase in the overall minimum wage rate index was moderated due to the freezing of the cost of living allowance. Wages of workers in agriculture rose by 1.1 per cent. Workers in industry and commerce experienced a high wage rate increase of 16.4 per cent in 1995. Workers in services experienced a 5.9 per cent wage increase during the year.

Employment

On the basis of available information, employment generation in 1995 appeared to have been around the same level as in the previous year. In 1994, the economy generated approximately 89,000 new employment opportunities. It is estimated that the economy can absorb about 60 per cent of the new entrants to the labour market. About one third of the employment generated in 1995 was in enterprises under the Board of Investment. On the basis of available information, the rate of unemployment in 1995 had dropped to 12.7 per cent in the third quarter of 1995 from 13.7 per cent in the third quarter of the previous year.

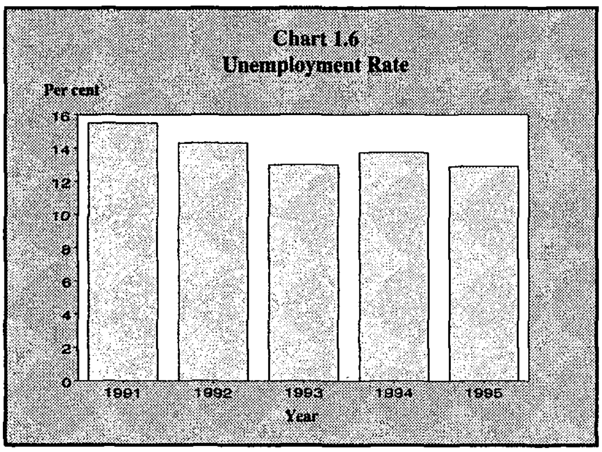


Chart 1.6
Unemployment Rate

All major sectors, except personal services and trade and hotels, contributed to the growth in employment in 1995. Employment in the agriculture, livestock and fisheries sector rose by 7 per cent, reversing the drop observed in 1994. Employment in manufacturing activities rose by 12 per cent as compared with a modest growth of 4 per cent in 1994.

Labour outflows for employment abroad continued to help ease the unemployment pressure in the labour market. A total of 170,000 persons are estimated to have secured employment abroad in 1995, reflecting an increase of 5.2 per cent over 1994. A major portion of these, approximately 66 per cent, were unskilled female workers. Data also reveal that demand for employment, particularly for housemaids, was increasing in non-Middle Eastern countries such as Singapore, the Maldives and Italy. However, Middle Eastern countries accounted for the largest share, about 92 per cent, of total departures, despite a stagnation of salaries and wages in those countries in recent years. Employment opportunities were also found in some of the fast developing Asian countries such as South Korea and Singapore.

In keeping with the Government's objective of improving employment opportunities, a Presidential Task Force was set up in late 1995 to ensure that the macro economic environment, fiscal incentives, the regulatory framework and human resource development policies in Sri Lanka were more conducive to employment generation.

1.3 Fiscal Policy and Budgetary Operations

The budgetary outturn in 1995 reflected significant progress towards fiscal consolidation, but fell short of the 1995 budgetary targets. The 1995 Budget, which was formulated within a three year fiscal framework for 1995-97, anticipated a sharp reduction in the fiscal imbalance for 1995 - turning the current account from deficit to a surplus of 0.6 per cent of GDP, reducing the overall deficit by 2.5 per cent of GDP, and reducing bank financing by Rs. 7,405 million or 1.1 per cent of GDP. The medium-term budgetary framework announced with the 1995 Budget emphasised the need to correct structural weaknesses in the Government's fiscal operations.

In the original 1995 Budget, the Government announced several measures to reduce the budget deficit. However, mainly in view of rising defence expenditures, the 1995 targets appeared too ambitious and a corrective policy package consisting of revenue enhancing and expenditure rationalising measures was introduced in mid-1995 to minimise fiscal slippage. The mid year corrections raised the defence levy from 3.5 per cent to 4.5 per cent, expected to expedite the privatisation programme to collect an additional Rs.1,000 million, imposed a levy of Rs. 1,500 million on the Ceylon Electricity Board, raised excise duties on 10 luxury items and imposed a 10 per cent expenditure cut in

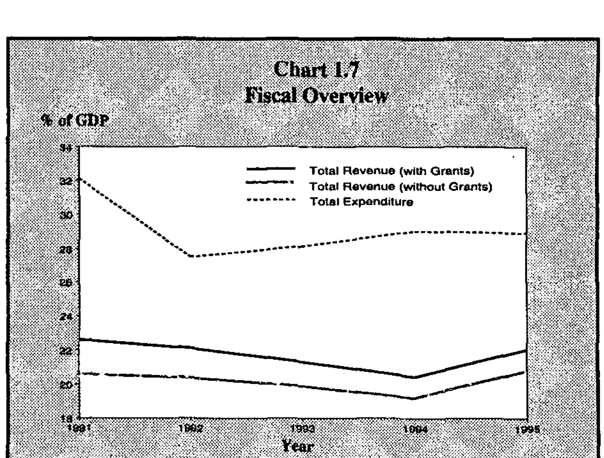


Chart 1.7
Fiscal Overview

non-priority capital projects. According to the budgetary outturn, total revenue rose from 19 per cent of GDP in 1994 to 20.6 per cent in 1995. Total expenditure was contained at 28.9 per cent of GDP as compared with 29 per cent in the previous year. The current account deficit dropped by about 1.4 percentage points to 1.5 per cent of GDP in 1995. The overall deficit after grants dropped from 8.5 per cent of GDP to 7 per cent of GDP. However, the target of making a net repayment to the banking system could not be achieved due to continuing structural weaknesses in the expenditure side and a shortfall in foreign financing as well as in the receipt of privatisation proceeds. Instead, bank financing increased by Rs.7,065 million or 1.1 per cent of GDP in 1995.

The Government's cash deficit during the first half of the year was almost entirely financed through non-bank sources. The cash deficit began widening during the second half. The increased resource needs of the Government during this period were initially met mainly through domestic market borrowings. This, coupled with a temporary liquidity shortage, led to high volatility in short-term interest rates. Towards end 1995, the Government resorted to increased bank financing. This reduced the pressure on interest rates and the immediate crowding out of private investment, but had an expansionary impact on money supply.

TABLE 1.3

Summary of Government Fiscal Operations (as a per cent of GDP)

	1985	1990	1994	1995 Provisional
Total Revenue	22.4	21.1	19.0	20.5
Current Expenditure	20.1	22.3	21.9	22.1
Interest	4.6	6.4	6.6	5.8
Salaries and Wages	4.2	4.9	5.1	5.5
Defence	0.3	0.7	1.9	1.8
Non - Defence	3.9	4.1	3.1	3.7
Defence other than Salaries	2.5	1.4	2.6	3.4
Pensions	1.7	1.4	2.3	2.3
Capital Expenditure and Net Lending	14.0	8.7	7.0	6.9
Current Account Surplus/ Deficit (-)	2.2	-1.2	-2.9	-1.5
Budget Deficit (before grants)	-11.7	-9.9	-10.0	-8.4
Budget Deficit (excluding defence)	-8.9	-7.8	-5.4	-3.1
Primary Budget Deficit	-7.1	-3.5	-3.4	-2.6
Financing	11.7	9.9	10.0	8.4
Foreign (including grants)	6.4	5.7	3.5	3.3
Domestic	5.3	4.2	6.5	5.1
of which: Bank	2.9	0.1	0.2	1.1

Source: Central Bank of Sri Lanka

Public Enterprise Reforms

The public enterprise reform programme of divesting state owned enterprises began in the late 1980s in Sri Lanka. In March 1995, the process of public enterprise reform was brought under the purview of a newly created institutional structure, the Public Enterprise Reform Commission (PERC). The reform programme generated Rs.3,001 million (Colombo Gas Company Rs.1,998 million, Capital Development and Investment Company Rs.371 million, plantation companies Rs.595 million and others Rs.37 million) in 1995, against a sum of Rs.4,000 million expected to be used for budgetary purposes. Further, the PERC initiated action to restructure several other enterprises during the year. Since the late 1980s, about sixty public enterprises had been divested or sold and a sum of Rs.15,650 million had been raised by end 1995.

1.4 The International Environment and External Sector Developments

The International Environment

Despite volatility in exchange and capital markets during 1995, there were positive developments in the international environment, with world economic growth being sustained at a satisfactory pace, inflation subdued and a decline in long-term real interest rates. Real output of industrial countries grew by 2.1 per cent with an average inflation rate of 2.4 per cent in 1995. Developing countries achieved a considerably higher average growth of 5.8 per cent, with a sharp drop in inflation to 19.5 per cent in 1995 from nearly 50 per cent in 1994. In particular, the Asian countries performed well, having an average estimated growth of 8.4 per cent and an average inflation of 11 per cent in 1995.

The high volatility in exchange rates experienced during the early part of the year when the dollar fell to an all time-low of 87 yen per US dollar was abated by the intervention of Japan and other countries. There was some improvement in addressing the problem of the trade imbalance between the USA and Japan. The exchange rates among key currencies, particularly the US dollar, deutsche mark and the Japanese yen, stabilised by the middle of the year. Among Asian currencies, the Indian rupee depreciated significantly from August onwards.

Meanwhile, with a view to providing momentum to their sluggish economic activity, both Japan and Germany reduced their discount rates during the year. The LIBOR picked up for other major currencies, namely the US dollar, French franc and pound sterling, in 1995.

Global trade continued to grow by nearly 8.7 per cent in 1995 following on a growth of 9 per cent in the previous year. Exports from developing countries sustained a growth rate of 12 per cent as in the previous year. Industrial country imports and exports grew by 7 per cent each in 1995. Meanwhile, with global shortages aggravated by higher demand for many essential agricultural commodities, prices rose significantly, in particular, for wheat, rice, sugar and milk products. World prices of manufactured goods and non-fuel primary commodities rose in US dollar terms, by 10.2 per cent and 8.5 per cent, respectively. Oil prices increased by 9.5 per cent in 1995. These partly reflected the impact of the depreciation of the US dollar in 1995.

The growth in global trade was supported by the decisions taken at the final Uruguay Round to be implemented through the World Trade Organisation (WTO) established in early January 1995. The WTO signified a major move towards a harmonious world trading system with minimal distortions. It brought virtually all sectors of international trade into the multilateral trading system, including services, intellectual property rights, agriculture and textiles and clothing. Deep tariff cuts, removal of non-tariff barriers, including the planned phasing out of quotas under the Multi Fibre Agreement by the year 2005, are expected to create a more competitive trading environment in the near future. The European Union too continued its move towards the final objective of removing economic barriers amongst its members. Regional trading blocks including the ASEAN countries and the SAARC countries continued to strengthen their ties.

The Mexican financial crisis in late 1994 affected other developing countries as well, with investors taking a cautious stance towards emerging financial markets. Many investors moved from emerging markets back to established markets in Europe and North America.

Economic restructuring continue in many developing countries with trade liberalisation and other structural reforms contributing to their robust economic performance in recent years. However, the crowding out of productive investment through large fiscal deficits and the quasi-fiscal involvement of governments adversely affected economic performance in many countries.

Meanwhile, the main growth centres continued to be the fast growing economies of Asia. China had an estimated GDP growth of nearly 11 per cent, while Korea (9.7 per cent), Vietnam (9.7 per cent), Malaysia (8.5 per cent) and Thailand (8.4 per cent) were among the fastest growing countries in the region.

The impact of changes in the international economic environment in 1995 had both positive and negative effects on Sri Lanka's economic performance. Enhanced foreign demand led to favourable price increases in both manufactured and agricultural exports. However, the terms of trade deteriorated marginally, reflecting the high import prices of essential commodities.

External Sector Developments

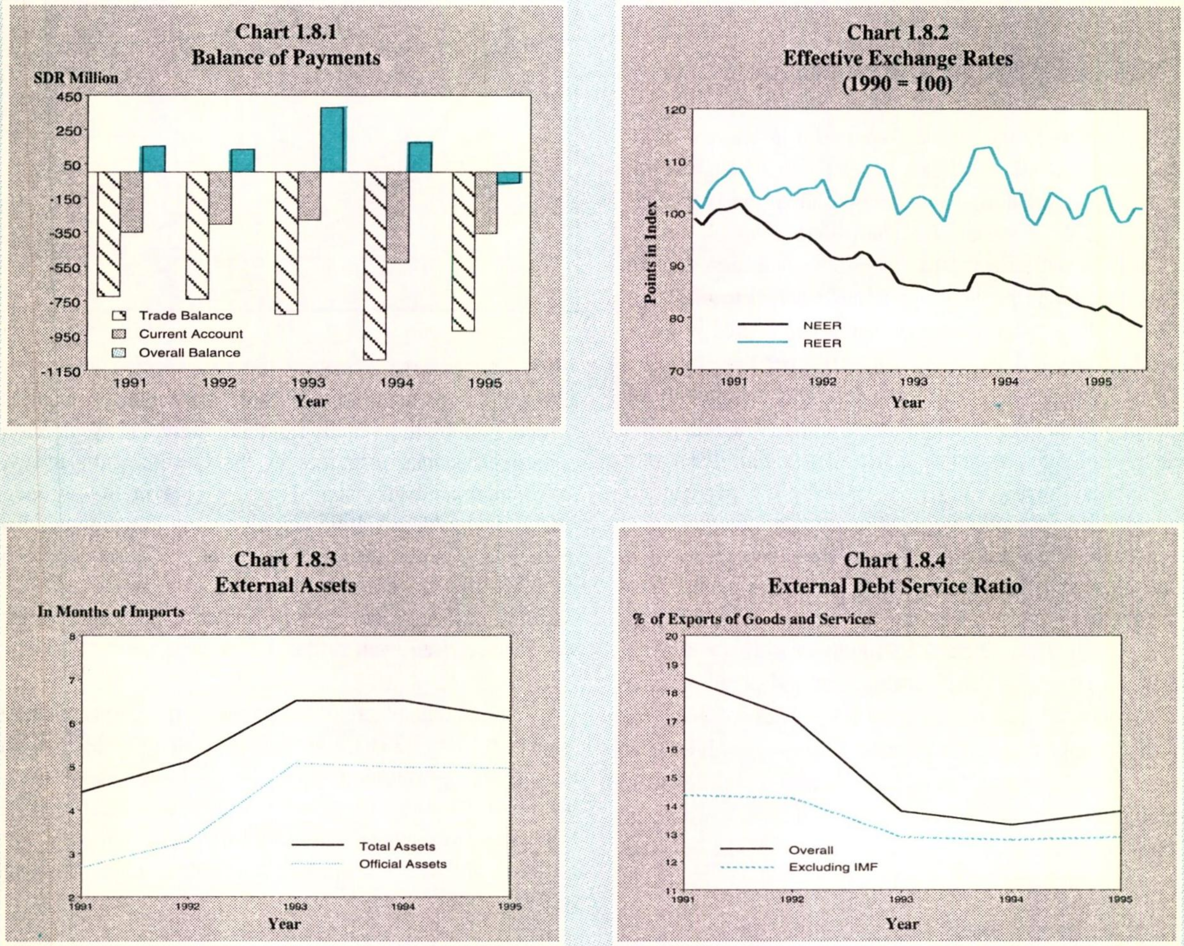
Following on five consecutive years of overall surpluses, Sri Lanka's balance of payments recorded an overall deficit of SDR 62 million in 1995. This was mainly an outcome of a decline in private capital inflows. Nevertheless, exports performed well and the trade and current account deficits dropped sharply. With improved export performance and a sharp drop in the growth of imports, the trade deficit narrowed significantly by SDR 168 million, or 2.5 per cent of GDP. This improvement in the trade account, together with a small surplus in the services account and higher net private transfer receipts, reduced the current account deficit from SDR 526 million in 1994 to SDR 358 million in 1995. The current deficit as a percentage of GDP dropped from 6.5 per cent in 1994 to 4.2 per cent in 1995.

Exports benefited from increased foreign demand, improved international prices for most agricultural and some industrial products, the depreciation of the exchange rate and favourable weather conditions for major plantation crops and registered a growth rate of 12 per cent in SDR terms in 1995. However, the import growth rate decelerated sharply to 3 per cent in 1995 from 16 per cent in 1994. The drop in imports arose from a reduction in capital good imports and in the demand for imports of durable consumer goods. The terms of trade declined by 1.3 per cent, with the rise in the prices of major import commodities outweighing the price increases for major agricultural export products.

Net capital inflows declined to half the level of the previous year, due to a reduction in private capital inflows. Net official capital inflows increased by SDR 32 million in 1995. There was an inflow of SDR 25 million from the privatisation proceeds of Colombo Gas Co. Ltd. However, direct foreign investment and privatisation proceeds together, dropped sharply to a third of the 1994 level due to the cautious attitude of foreign private investors owing to labour unrest, uncertainties regarding the domestic security situation and the completion of large capital projects. Inflows of private loan capital also dropped, mainly due to the tapering off of Air Lanka's financing arrangements under their refleeting programme and a decline in short-term trade credits.

Meanwhile, on the policy front, there were several positive developments. The tariff structure was further rationalised during the year by reducing the maximum tariff, reducing the number of tariff rate bands to three and reducing ad hoc exemptions. The exchange rate remained

Chart 1.8
Selected External Sector Indicators



largely market determined and reflected underlying macroeconomic fundamentals. The external payments system continued to be transparent with the convertibility of the rupee assured for all current account transactions, debt repayments and foreign investment abroad on a case by case basis.

During the first quarter of 1995, the third year arrangement under the Enhanced Structural Adjustment Facility (ESAF) with the International Monetary Fund (IMF) was permitted to lapse without the second instalment of SDR 56 million being drawn as the new administration intended to negotiate a new arrangement with improved policies. External sector transactions led to a drop in Sri Lanka's gross external assets by SDR 63 million during 1995. The level of gross external assets, at SDR 1,729 million at end 1995, was sufficient to finance 5.4 months of imports projected for 1996. The debt service ratio as a percentage of earnings from goods and services rose marginally to 13.8 per cent, from 13.3 per cent in the previous year.

Amidst high volatility in exchange rates among major currencies and an overall deficit in the balance of payments the Sri Lanka rupee depreciated against the US dollar, the intervention currency, by 7.5 per cent, and by 9.5 per cent against the SDR, during the year. With a point-to-point inflation of 11.5 per cent relative to 5.5 per cent inflation amongst trading partners and competitors, the depreciation of the nominal exchange rate was sufficient to maintain the country's international competitiveness as measured by the Real Effective Exchange Rate (REER).

Tourism

The tourism sector suffered a major setback in 1995. Tourist arrivals which grew at 5 per cent until the end of the third quarter, dropped by 17 per cent in the fourth quarter. During the year as a whole, tourist arrivals dropped by 1 per cent and earnings from tourism dropped by 7 per cent.

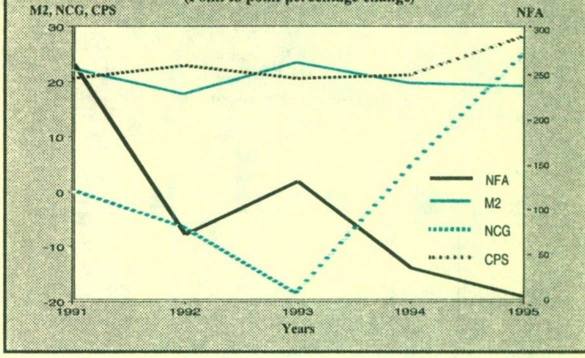
1.5 Monetary Sector Developments

During 1995, monetary expansion remained high primarily owing to a significant acceleration of bank credit to the private sector during the second half of the year. This took place in the context of a sharp drying up of foreign capital inflows and a depressed domestic capital market. Both the Government and public corporations resorted to increased bank credit. As a result, the money supply measured in terms of Broad Money (M_2) expanded by 19.2 per cent in 1995 as against 19.7 per cent in 1994. This was a high rate of monetary growth considered in the context of a real GDP growth rate of 5.5 per cent. However, it is significant that Narrow Money supply (M_1) grew only by 6.7 per cent in 1995, compared with 18.7 per cent in the previous year. The faster growth in M_2 than in M_1 was mainly a result of a compositional shift in the asset portfolio of the public from idle balances to interest bearing assets at a time of high positive real interest rates. The intensification of deposit mobilisation efforts and the development and popularisation of new financial instruments and services offered by commercial banks helped the process. A slow growth of new deposits in the National Savings Bank due to its delay in responding to rising interest rates, and a shift of investments by the public from a depressed stock market to the banking sector also contributed to this shift.

The banks accommodated increased credit demand by both the private sector and the public sector through economising on reserves, aggressive banking practices to mobilise new deposits in a more competitive banking environment and reducing foreign held balances. As a result, net domestic assets of the banking system increased sharply by 27 per cent. The growing demand for credit by the private sector increased, owing to a drying up of capital inflows from abroad, a reduction in funds obtainable through a depressed share market and liquidity problems faced by business enterprises as a result of lower than usual turnover, towards the end of the year. Thus, despite high and rising interest rates, credit to the private sector rose by 29.5 per cent in 1995 compared with an increase of 17.7 per cent in 1994. Increased bank borrowings of the Government towards end 1995 due to a widening of the cash deficit on account of enhanced defence and subsidy expenditures and revenue shortfalls fuelled the credit expansion further in 1995.

Growth in credit to the Government from the banking system took place almost entirely during the second half of

Chart 1.9
Changes in Monetary Aggregates
(Point to point percentage change)



1995. The adverse monetary impact of escalating defence and welfare expenditure was seen particularly during the second half of the year when there were heavy claims on domestic financial resources by the Government. However, as commercial banks sold Treasury bills in the secondary market towards end 1995, credit to the Government from commercial banks declined marginally. Consequently, net credit to the Government from the Central Bank rose by Rs.7,662 million, if not for which interest rates in the market would have risen even further.

In 1995, bank credit to public corporations increased notably by Rs. 3,364 million, in contrast to a sharp decline during the previous two years. This reflected higher borrowings by the Ceylon Petroleum Corporation (CPC) following the damage to its oil storage facilities (Rs.1,297 million) and the Co-operative Wholesale Establishment (CWE) owing to escalating world wheat prices (Rs.644 million).

As the balance of payments was in overall deficit, there was no pressure on money supply from the external front unlike in the previous year. Net foreign assets (NFA) of the banking system increased only marginally, by 3.2 per cent, and this was due to the exchange rate impact. NFA of the Central Bank rose by 12.8 per cent following an increase of 24.3 per cent in 1994. Meanwhile NFA of commercial banks dropped, as there was an accumulation of non-resident deposits without a corresponding increase in assets held abroad.

The banks shifted their portfolio from less attractive foreign assets to more attractive domestic assets due to a widening of the interest rate differential between foreign currency deposits and domestic financial assets. Gross foreign assets of commercial banks fell, reflecting a reduction in deposits with FCBUs and balances with banks abroad.

Reserve money or high powered money increased by 15.5 per cent in 1995 as compared with 20.5 per cent in

1994. From the sources side, the expansion of net credit to the Government contributed to the growth in reserve money. This was reflected in an increase in currency in circulation and commercial bank deposits. It was noteworthy that almost sixty per cent of the growth in reserve money occurred in December.

The income velocity of money continued to decline, reflecting reduced inflationary expectations and the increased attractiveness of banking sector assets. During 1995 the money multiplier remained stable at around 2.9, following the trend observed in the past few years.

In 1995, the environment within which the Central Bank was called upon to conduct monetary policy differed significantly from the environment which prevailed in the past five years. A sharp expansion in net foreign assets arising from large capital inflows during the last five years fuelled monetary growth. This was absent in 1995, as there was an overall deficit in the balance of payments. Thus, the growth in money was essentially caused by a rise in domestic credit. The challenge faced by the Central Bank in formulating monetary policy in 1995 was, therefore, to contain the credit growth, thus avoiding the ill-effects of an unacceptably high rate of monetary expansion, while ensuring that the system had sufficient liquidity to avoid stifling economic activity. The monetary policy continued to be tight during the year. The high Statutory Reserve Ratio (SRR) of 15 per cent was maintained throughout the year. However, to ensure that productive economic activities were not unduly suppressed by liquidity tightness and very high interest rates, the Central Bank relaxed its tight monetary policy somewhat by purchasing Treasury bills and permitting limited foreign borrowing by financial institutions towards end 1995.

The Bank continued to rely on open market operations as the main instrument in conducting monetary policy, using both its portfolio of Treasury bills and its own securities. With the mopping up of excess liquidity in the system, the Treasury bill holdings of the Central Bank fell from Rs.5,099 million at end 1994 to Rs.2,991 million at end March 1995. In order to contain the growth of money, the Central Bank issued its own 3-month securities in order in the second and third quarters with average yields per annum ranging from 14.08-18.10 per cent.

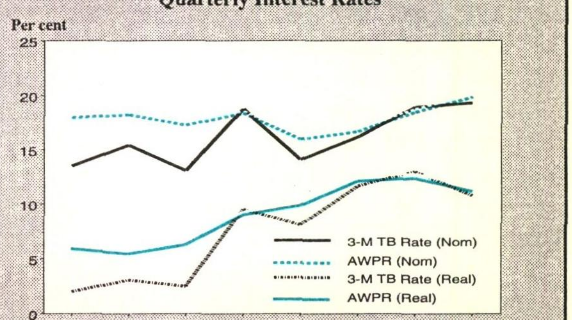
Slowing down of foreign capital inflows and increased domestic demand for credit led to a shortage of liquid funds and a corresponding rise in interest rates towards the end of the year. There was also increased demand for credit by the Government due to heavy expenditure commitments at the end of the year. Reduced inflows from abroad, the inability to raise funds in a sluggish stock market, inflationary expectations and cash flow problems of the corporate sector contributed to a heightened demand for bank credit from the private sector. As a result, Treasury bill yields increased from 14.34 per cent in March to 18.68 per cent in December. Call money rates rose from 18 - 25 per cent in March to 20 - 58 per cent by end December. Further, the money market displayed extraordinary volatility in the movement of daily call money rates reflecting speculative behaviour.

The Central Bank purchased Treasury bills in the secondary market and retired its own securities on maturity to ease the tightness in the money market. It also commenced a Reverse Repurchase facility in November with a view to providing liquidity to the market on an overnight basis and also to dampen speculative activity in the call market. The rediscount rate, which is charged on Treasury bill sales to the Central Bank, was also reduced. Further, the Central Bank decided in late December that effective from the beginning of 1996, commercial banks would be permitted to borrow abroad, upto 5 per cent of their capital and reserves. This measure was also another step towards liberalising capital transactions. The Bank also used moral suasion to discourage commercial banks from lending to their customers for speculative purposes. Consequently, stability was restored to the money market. The resultant enhanced liquidity led to a moderation in interest rates in the market.

The Central Bank continued to maintain the SRR at a relatively high rate of 15 per cent throughout the year. In order to contain domestic credit expansion, foreign currency deposits placed abroad continued to attract a concessionary SRR of 5 per cent. The Central Bank also refrained from granting new credit under the Medium and Long Term Credit Fund (MLCF), although requests for finance from distressed finance companies continued to be accommodated on a case by case basis and on a very limited scale.

Short-term interest rates dropped in early 1995, reflecting a significant easing of liquidity mainly due to the retirement of Central Bank securities, increased provisional

Chart 1.10
Quarterly Interest Rates



advances to the Government and transfer of Central Bank profits to the Government. This trend reversed itself sharply from the second quarter. Consequently, the average yield rate on 12-month Treasury bills which declined from 19.43 per cent at end 1994 to 14.00 per cent in February 1995, progressively rose to a peak level of 20.5 per cent by mid October. Thereafter, the rates dropped slightly until end 1995, but remained above 18 per cent. Call money market rates followed the same trend with a high volatility during the second half of 1995. The medium and long term rates recorded some fluctuations during the year.

The Colombo stock market activities were sluggish, mainly due to the low level of foreign participation. Attractive positive real interest rates also caused a shift of investments from the stock market to the banking sector. The All Share price Index dropped by 33 per cent and the Sensitive Price Index dropped by 31 per cent in 1995.

During 1995, a further step towards financial sector reforms was taken by amending the Credit information Bureau Act, the Banking Act, the National Savings Bank Act, the Monetary Law Act, the Registered Stocks and Securities Ordinance and the Local Treasury Bills Ordinance. These amendments are expected to provide a legal framework to improve the secondary market in government securities, to improve the efficiency of state sector financial institutions and to strengthen the regulatory framework of the financial sector.

1.6 Problems and Issues

Although the dynamism of Sri Lanka's leading growth sector, Manufacturing, was laudable, during the year this sector was affected by labour unrest which was later resolved by Government intervention. While an attempt was made to codify the working conditions and rights of labour in the form of a Workers' Charter, employers and investors expressed misgivings about the move, entirely influenced by the spate of strikes. Workers and employers are well aware of the need to remain competitive in the world market and that it will be important to build up a spirit of co-operation. The Government will have to be mindful of the need to create greater flexibility in the labour market, especially in the context of a large unemployed workforce. A recognition by all parties of the need to link wage increases to productivity increases will have to be the basis of all wage negotiations in export oriented industries, which face stiff competition.

Resource flows into the industrial sector were affected by the slowing down of foreign capital inflows. This, coupled with the depressed stock market, led enterprises to resort to increased bank credit, despite rising interest rates. Lack of infrastructural facilities was another factor hindering the growth of the industrial sector. When considered in the context of these difficulties, the industrial sector has demonstrated a commendable resilience in 1995.

In addition to the common problems faced by the industrial sector in general, some textile manufacturers who relied on the local market experienced serious marketing problems due mainly to competition from imported and smuggled textiles. The gradual reduction of import tariffs on textiles from 100 per cent in 1993 to 35 per cent in 1995 also reduced the protection enjoyed by the domestic textile industry. The textile production of seven major manufacturers dropped by 17 per cent in 1995. While the loss of employment and output in the textile manufacturing industry is a matter for serious concern, one would also need to weigh the gains to consumers against the losses to producers that result from enhanced competition. The enhanced competition would improve resource allocative efficiency and compel firms to be more cost effective and improve product quality. In fact, more efficient producers who targeted their output to export markets survived under the new challenges. However, the interests of local manufacturers who need more time for adjustment could be safeguarded through enhanced surveillance at the ports. The local textile industry needs investment in modern technology, together with greater dynamism, to be cost effective and competitive, as further tariff cuts are expected in the medium-term.

With the establishment of the World Trade Organisation (WTO) in January 1995, all existing bilateral textile agreements that came under the Multi-Fibre Arrangements (MFA) were telescoped into the Uruguay Round Agreement on Textile and Clothing (ATC). The ATC has developed a framework for the full integration of textiles and apparel into the multilateral trading system and to phase out quotas over a ten year period, aimed at creating a completely free trade in textiles and clothing by the year 2005. Therefore, it is of paramount importance that Sri Lanka be prepared to face stiff competition following the phasing out of MFA provisions.

In agriculture, while the plantation sector policy became more transparent and significant progress was made towards improving the efficiency of that sector, the non-plantation agriculture sector was affected by the interplay of several factors. There was a bumper paddy harvest which exerted downward pressure on rice prices. This situation was aggravated by the wheat flour subsidy which changed the relative prices against paddy farmers. As consumer demand shifted towards cheaper wheat flour based products, there was further downward pressure on rice prices. This was one of the justifications for the increased presence of the Paddy Marketing Board (PMB) in the market to purchase paddy at a guaranteed price. While the PMB purchased nearly 10 per cent of the total paddy output in 1995, the commercial viability of its operations was seriously challenged as it was not able to dispose of its accumulated stocks. Eventually, the PMB carried a debt of over Rs.2 billion to the domestic banking system.

The continuation of the import licensing of certain agricultural products (potatoes, big onions and chillies) undermined the transparency of the trade policy regime. These import licensing requirements are a form of quantitative import controls and acted as a deterrent to efficient functioning of markets, with heavy costs to the consumers. In addition, these restrictions were a bar to the disinvoking of the balance of payments clause in Article XVIII (B) of the GATT/WTO. Instead of licensing, a variable tariff system would be more appropriate to provide the required protection to farmers as the discretionary element would then be avoided. In addition, a transparent and consistent policy in this area would encourage private sector participation in the storage and distribution network for these agricultural products.

The experience during the period of structural adjustment and growth has demonstrated that the economy of Sri Lanka has the potential to withstand many challenges arising from external or domestic shocks. A number of structural adjustment measures have been implemented, including an overhaul of development strategy from a state regulated to a market oriented setting to promote private sector led growth. These policy reforms included liberalisation of the trade and payments system, pruning of indiscriminate welfare subsidies in the budget, correction of relative price distortions including exchange and interest rates, liberalisation of foreign investment regulations, major tariff reforms, privatisation of state owned enterprises, financial sector liberalisation and domestic market deregulation. Subsequently, these policy reforms were further strengthened.

The policy reforms have brought many benefits to the economy. Initially accompanying these reforms were large inflows of foreign capital to fill the gap between investment and domestic savings. The economy was able to raise domestic investment from about 15 per cent of GDP in the mid-1970s to above 30 per cent during the early 1980s which was the peak period of the early infrastructure development drive. The country's rate of unemployment dropped sharply and economic expansion accelerated to above 5 per cent from a stagnant growth rate in the pre-reform period. The benefits of growth spread to many sectors of the economy. Most sectors of the economy showed dynamism, in particular, the Manufacturing and Services sectors.

However, during the initial investment drive, the real benefits to consumers began eroding quickly due to expansionary financing of fiscal deficits, funded through foreign capital inflows, as well as domestic bank financing. The severe imbalance of fiscal operations, with the budget deficit averaging 19 per cent during 1980-1982, became a threat to both monetary and price stability. The inflation rate as measured by the CCPI averaged 18.3 per cent during this period. The high inflation and the increased claims on domestic resources by the Government discouraged private investment, thereby undermining the development strategy. While part of the development expenditure was financed through foreign borrowings on commercial terms, the maintenance of a viable external position too became a serious challenge. The high inflation and capital inflows resulted in a real appreciation of the exchange rate, a rise in external debt and raised the debt burden in terms of the debt service ratio, as well as the debt to GDP ratio. Within the next few years inflation was brought under control through a short-term stabilisation programme which included pruning of capital expenditure. However, inflation remained at double digit levels until the mid-1980s.

Economic management problems became complicated once again with the eruption of the internal conflict with the Northern terrorist group. This has led to a sharp rise in defence expenditure. However, the country's structural adjustment programme continued, mainly with increased emphasis on privatisation, rationalisation of the tax system, further trade reforms aimed at reducing effective protection and financial sector reforms aimed at improving the efficiency of the financial sector. The country made significant headway in most of these areas.

Despite these achievements, Sri Lanka has been lagging behind fast growing economies in the growth process. There is an urgent need to increase the rate of capital formation to enhance economic expansion without which the country would lose even its significant past achievements in human development. The investment to GDP ratio, which stood at 23.8 per cent in 1985, dropped to 21.7 in 1989 due to resource constraints. Since then the ratio has improved gradually to 25 per cent in 1995. However, this level of investment is not sufficient to provide a basis for accelerated growth in the medium and long-term. The country appears to have reached the limit to which resources could be made available for enhanced investment from the public sector. Hence any further growth in investment needs increased participation of the private sector.

While adjustments that have been made on the fiscal front to contain the budget deficit in the recent past should be commended, avenues should be sought to economise on budgetary resources. Increased defence expenditures have affected the entire economy, but on the fiscal front, most of the required adjustments fell on capital expenditure, in addition to raising the level of domestic and foreign debt. Debt financing of the deficit has created a vicious circle and hence, immediate alternative avenues have to be found to avoid a debt trap.

The increased resort to bank financing is not advisable as it is expansionary and crowds out private sector investment. Excessive growth in monetary aggregates affects the price level both directly and indirectly. If the money supply is permitted to increase beyond a certain level, given the limited existing production capacity, the consequence would be an increase in aggregate demand and a rise in the general price level. A more insidious, and perhaps potentially more dangerous, effect of a continued increase in money supply would be to build up the inflationary expectations in the system, thereby causing the velocity of money to increase, which would not be easily reversible. These would be the direct effects of expansionary money supply. Hence borrowing from the Central Bank for financing deficits should be discouraged.

In a country such as Sri Lanka, where imports are significant, an expansionary monetary policy would also affect inflation indirectly. Given limited domestic production, an expansion in the money supply would raise aggregate demand (money spending) leading to increased imports, an increasing balance of payments deficit and consequent pressure on the exchange rate. However, the price pressures due to excessive monetary expansion will not be reflected in the realised inflation rates as long as the country's foreign exchange balances are sufficient to meet additional demand. The continuous depletion of external assets would however exert pressure on the exchange rate, which would eventually lead to a sharper depreciation. The resulting increase in import prices would raised the general price level and lead to pressures to increase wages. Rising import prices and wages would cause cost push inflation, leading to further depreciation and inflationary expectations becoming entrenched in the plans of producers and consumers. This circle of events would once again be the beginning of spiraling inflation.

As in many other developing countries, price changes in Sri Lanka are also caused by structural factors such as seasonal fluctuations in supply, constraints in storage and transport facilities, labour market rigidities and imported inflation. Expansionary monetary policy would aggravate price increases arising from these structural factors. However, when there are other macroeconomic imbalances such as a large fiscal deficit, due to structural constraints, reducing inflation to very low levels may not be feasible or desirable, as such an attempt could perhaps drive the economy into a recession. A gradual reduction in the inflation should therefore be targeted and should be accompanied by a correction of the structural imbalances.

The budgetary management in the medium-term needs to address the basic issue of maintaining a proper balance between the traditional functions of the Government of providing security and defence, essential services and basic needs on the one hand, and promoting economic growth on the other. In this regard, it is essential that economic activities which can be efficiently handled by the private sector, including the development of infrastructure, should be left to the private sector while keeping the regulatory role of the State to a minimum. This would provide a sound and sustainable basis for improving the efficiency of resource allocation, accelerating investment and maintaining non-inflationary economic growth.