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SRI-LANKA - LIBERALISED ECONOMIC POLICY REGIME: AN EVALUATION OF THE FIRST TEN YEARS

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ABSTRACT

The object of this paper is to evaluate the liberalisation of the economy in Sri Lanka in 1977 by closely examining macroeconomic performance during the period 1978-1987. The paper first traces the historical evolution of the Sri Lankan macroeconomy upto 1977 followed by a discussion of the liberalisation measures undertaken in 1977. Thereafter a detailed evaluation of the developments in the Sri Lankan economy during 1978-1987 is undertaken with special attention being paid to its internal and external balance. The paper concludes that contrary to expectations, the liberalisation did not bring about the desired results due to adverse exogenous developments and inconsistencies in macroeconomic policy formulation and implementation.

Key Words : Sri Lanka, economic liberalisation, macroeconomic developments, economic development.

Journal of Economic Literature Classification : E65, F13, O11, O53

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1.0 Introduction

This paper has six sections. The next section examines the economic policy changes that have taken place in Sri Lanka since independence in 1948, particularly during the period 1960-1977. Section Three details liberalisation measures undertaken in the country in 1977 while results of the liberalisation exercise are discussed in Section Four. The core of the paper is Section Five which relates to a critical evaluation of the post-1977 liberalisation experience in the Sri Lankan economy. That evaluation is carried out under two headings, i.e. the disequilibrium in the domestic economy and the resulting imbalances in the external sector, in order to ascertain why the policy reforms failed to achieve the desired results. The paper is concluded with a post-script on the economic policy reform of 1977.

2.0 Economic Policy up to 1977

Pre-1956 Period: Sri Lanka, (until 1972 known as Ceylon), a developing nation of 65,415 sq. km. with a population of 17.6 million by mid-1993, gained political independence in 1948 after 133 years of British rule. Even though previously the Portuguese and then the Dutch ruled the country nearly for three centuries among themselves, the basically self-contained peasant economy mainly centering around rice cultivation did not undergo a fundamental change. It was the British who laid the foundation for the modern export economy of today.

The Sri Lankan economy at independence in 1948 was a relatively open dual economy. In 1947, 33.8% of the country's national income was accounted for by the export sector (Wickrameratne 1977, p.136). In the dual economy, on the one hand, the modern sector was basically an exporter of primary products such as tea, rubber and coconut and there existed a market for imported consumer goods and a limited amount of investment goods and services (part of it was financial) to cater to a handful of local industries. Most of the service institutions such as banking and insurance were foreign-owned. On the other hand it was the subsistence agriculture that dominated the traditional sector. Cultivation of rice and other food crops and cottage industries were the main livelihood of the peasantry occupying the commanding position in the traditional sector.

Sri Lanka had a fixed exchange rate regime with a currency fully convertible into the pound sterling. From 1948 to 1956 the trade regime was relatively neutral with few quantitative controls, and low export duties were matched by similarly low import tariffs. Moreover, government policy during this period was that of minimal intervention. The United National Party (UNP) government willingly improved upon the colonial economic pattern, the private sector being allowed to play a dominant role in the national economy. Even though some attempts were made at import substitution industrialisation by the government focusing on plywood, leather, ceramic and glass, little or no protection was provided through tariff and quantitative restrictions. The myopic private sector was reluctant to enter into import substitution ventures, presumably due to the perception that profits from such ventures would be transitory.

The most notable episodic feature during this period was the Korean war boom which improved Sri Lanka's terms of trade in the early 1950s and raised export revenues on a massive scale. With the downturn in the world economy in the mid-1950s, Sri Lanka's export prices began to decline and by 1954 the country's foreign exchange reserves fell by nearly 50%.

During the first half of the 1950s, the changes in Sri Lanka's balance of payments were therefore a reflection of the cyclical fluctuations within her major trading partners. But it should also be noted that monetary and fiscal measures were very often out of tune with the external situation. The three main causes for the loss of external assets after 1952 were, falling export incomes, rising import values, and the higher consumption levels sustained and swollen by an excessive expansion of money supply to finance the heavy government budget deficit. The main cause of the budget deficit was the food subsidies and other welfare expenditures of the government. The need to curtail the food subsidies was felt strongly and in 1952, under an austerity programme, the government made an attempt to cut the food subsidy bill and an import surcharge of 10% was added to the existing import duties on less essential goods. These measures resulted in a remarkable recovery of Sri Lanka's current account in the balance of payments. The cost of opportunities missed, especially those arising from the Korean boom, were immense. After the Korean war boom when Sri Lanka's exports were not expanding at a fast enough rate, new products were not forthcoming. The misdirected efforts of export promotion and import substitution increased import dependence further. The adverse balance of payments situation[1] emerged as the biggest constraint against the expansion of output, income and employment.

During the early 1950s Sri Lanka's real GNP growth rates remained at fairly high levels averaging 5.8% per annum for the period 1951-1955 (Snodgrass 1966). Subsequently the Sri Lankan economy recorded a negative GNP growth rate of 8.4% in 1956 while the annual average real GNP growth rate for the period 1955-1960 also dropped to only 3.5 per cent. These lower growth rates emerged as the biggest constraint on expansion of employment.

1956-1977 Period : The government that was elected in 1956 viewed economic policy as essentially state-controlled. The election manifesto of the coalition which won the elections in 1956 declared that all key industries must be run by the State and all essential industries, including foreign-owned plantations, transport, banking and insurance, would be progressively nationalised. The declaration held out the prospects of an economy in which the private sector would progressively contract and play a diminishing role. Soon after coming to power the new coalition government took over the privately-owned omni bus transport services.

Thus after 1956, Sri Lanka swung away from the relatively free economic arrangements inherited from the British Colonial period to one of increasing restrictions. Since then, economic policy tended to become more and more inward-oriented. For about two decades thereafter, from 1956 to 1977, excepting the brief period from 1967-1969 when some relaxation of import controls occurred, the economy was subject to increasing restrictions and controls. After 1956 a conscious effort was made to take the country towards import substituting industrialisation and at the same time economic policy tended to give weight to the public sector while opportunities for the expansion of private business activities were rather limited. Despite all these changes, up until the end of 1950s Sri Lanka was essentially an open economy with only a minimum of exchange and trade controls.

[1] The current account deficit of the balance of payments in Sri Lanka from 1950 to 1955 was 1.4% of GDP on an annual average basis (Snodgrass 1966).

The deteriorating balance of payments situation from 1959 onwards prompted the government to impose exchange controls in 1960 and 1961. Subsequently these exchange control measures came to be used as a means of industrialising behind a wall of high tariffs and stringent import controls. Various measures of trade protection were adopted by the government including high duties on imports of motor vehicles, petroleum products, textiles, tobacco, cigarettes and watches and high duty rates on the export of cinnamon, coir fibre and papain. With the raising of overall levels of protection and the increased variance of effective rates of protection, imports of consumer goods, intermediate goods and capital goods declined substantially.

The boost to import substituting industrialisation provided by the controls in the early 1960s was later supplemented by the government's introduction of a comprehensive industrial policy. Domestic restrictions became pervasive and encompassed investment licensing, differential interest rates favouring industry and various forms of interventions in the labour market. Among these were minimum wage laws, restrictions on firing, and social security legislation.

Consequent on the trade and exchange restrictions between 1960 and 1962, the economic policies of the government became increasingly restrictive. The major features of the restrictive trade regime that evolved up until 1977 were as follows:

First, increasingly tariffs were replaced by quantitative restrictions as the major policy device (Lal and Rajapathirana 1985). Initially goods arbitrarily categorised as luxury goods were subject to higher revenue tariffs and increased cash margins were imposed on letters of credit. But from the mid-1960s, these restrictive tariffs were gradually converted into quantitative restrictions. There was an effective ban on luxury goods by the middle of 1970 while quotas and licences were enforced on all imports.

Second, a highly differentiated import tariff structure was put in place with import tariff rates ranging from 10 per cent to 300 per cent, differentiated in accordance with the degree of competition with domestic import substitutes. While this discriminatory trade regime was a boost to domestic industry between 1962 and 1965, the high level of effective protection provided by the import restrictions began to discriminate in favour of final goods and against intermediate goods.

Third, the restrictive trade regime was accompanied by controls on direct foreign investment. The White Paper on Foreign Investment issued in 1966 further tightened the restrictions on the repatriation of dividends and profits imposed under the exchange control regulations. While the Business Undertakings (Acquisition) Act of 1971 and the nationalisation of a number of foreign enterprises discouraged foreign investments, by 1972 more stringent restrictions came into force including the Companies (Special Provisions) Law of 1974 which empowered the government to nationalise foreign-registered companies.

In January 1961 more stringent exchange control measures were taken. The recourse to stringent exchange controls was an inevitable outcome of the maintenance of an overvalued exchange rate. Foreign exchange required for the country's economic development was rationed through import and exchange controls which pushed up the free market price of exchange. In 1964, the allocation of foreign exchange through the Foreign Exchange Budget Committee began with strict foreign exchange controls on overseas education and foreign travel already in place. By this time a moratorium was imposed on the repatriation of dividends and profits by foreign-owned companies in order to conserve foreign exchange. These restrictive measures on foreign exchange gave rise to many hardships and were by themselves inefficient and inequitable.[2] By the mid-1960s the overvalued exchange rate was combined with a stringent system of quantitative restrictions replacing the tariff as the major protective device.

Eventually it was realised that the overvaluation of the Sri Lankan Rupee had to be corrected. The opportunity came when the British pound was devalued in November 1967. The Rupee was then devalued by 20% against the U.S. dollar and by 7.6% against the pound and a limited liberalisation of trade was undertaken. Later in 1968 a dual exchange rate system favouring non-traditional exports was adopted, while the open general license system for imports was reintroduced. This mini-liberalisation during 1967-69 was undertaken in the context of balance of payments difficulties, slow export growth and low commodity prices and was thus bound to fail.

[2] Despite the emerging restrictive regime in the early 1960s Sri Lanka achieved a modest annual average real GDP growth of 4.0% (Table 1).

In 1970 when a new government with centre-leftist views came into power, the mini-liberalisation exercise was completely reversed. The 1970-77 period witnessed the most restrictive economic regime in the country. Once again quantitative restrictions on imports were imposed. However the new government also paid attention to export development and as a result an Export Promotion Secretariat was established. For the first time in Sri Lanka's history an Export Development Plan was prepared and incorporated as a component of the Five Year Plan for the period 1972-1976. While maintaining the multiple exchange rate regime, as an encouragement to non-traditional exporters, a Convertible Foreign Currency Scheme was introduced in the early 1970s. The dual exchange rate and the Convertible Foreign Currency Scheme undoubtedly reduced the bias against exports. Manufactured exports which accounted for only 5% over first half of 1960s increased their relative share in total exports to 14.6% by 1978 (Rajapathirana 1988, p.1147).

However with the emergence of a highly distorted economy arising out of pervasive controls on trade, investment, labour markets and finance, the agricultural sector and agricultural exports, in particular, suffered severely. Throughout the post-independence period, Sri Lanka experienced extensive government interventions in both product and input markets. Many of these interventions originated during the Second World War when the British began to use extensively price controls and rationing to overcome war-time scarcities. Essential consumer goods such as food and textiles were subject to the price control and rationing schemes were operated directly by the government. Even though some of these schemes were dismantled after the War, successive governments in the post-War era allowed both price controls and the rationing of subsidised foods, especially rice, to continue on equity and welfare grounds. As the country's import capacity weakened with the terms of trade deterioration in the early 1970s, the coverage of price controls and rationing was extended to other items such as sugar, flour, onions, matches, tooth paste, shirts, transistor and torchlight batteries and synthetic textiles, to name a few (Athukorala and Jayasuriya 1993). By 1975, hardly any consumer good was exempt from price controls except for tea, rubber, gems and some other export crops.

The period from 1951 to 1976 in Sri Lanka has been characterised as a classic case of financial repression (Khatkhate 1982b). As discussed further below there was increased government intervention in the financial sector in the early 1960s including the nationalisation of the Bank of Ceylon, the establishment of the Peoples' Bank and restrictions on the operations of foreign-owned banks. According to Lal and Rajapathirana (1985), up until 1977 Sri Lanka had a retarded financial system with a variety of controls which included interest rate and credit ceilings, selective credit controls and differentiated access to Central Bank refinance. Credit rationing and very low or negative real rates of interest were the two basic features of the financial retardation. Interest rates were kept at a low level to allow investments to grow. Since these rates did not reflect the market equilibrium price for capital, controls of all sorts had to be imposed to regulate and direct them. For instance a system of directed credit to increase term lending was commenced with the establishment of the Medium and Long Term Credit Fund by the Central Bank of Sri Lanka in 1964. Such bureaucratic allocation of credit may not have been in the best interest of future growth since such term lending, most of the time, was not directed at high-yielding projects. As well the monetisation of the government budget deficit at an increasing rate resulting in increased inflation, and the administrative determination of interest rates, were the major reasons behind the negative interest rates. In the 1950s government borrowings from the Central Bank averaged around 2.5% of nominal GDP while this ratio increased to 14.8% from 1961-1968 (Khatkhate 1982b, p.832). Inevitably the high annual average inflation rate of 10.9% between 1971-77 (see Table 1) resulted in negative real interest rates thus discouraging savings and encouraging a higher rate of consumption.

Nationalisations and state entry into commercial undertakings resulted in a large increase in the government's direct control over trade and commerce after 1960. With the intention of nationalising the importation and distribution of petroleum products, the Ceylon Petroleum Corporation (CPC) was established as a 100% government corporation in January 1961. The nationalisation took place in 1962, and by 1964 the CPC monopolised the importation and distribution of petroleum products. During 1961-1964 the insurance business was monopolised in successive stages under the government-owned Sri Lanka Insurance Corporation. State participation in the banking system was substantially increased in 1961 with the establishment of the Peoples' Bank, to increase banking facilities to the rural sector, and the nationalisation of the Bank of Ceylon. In order to make the banking business more indigenous, through an amendment to the Finance Act, the opening of new branches in the island by foreign banks and the opening of bank accounts by Sri Lankan citizens with foreign-owned banks was prohibited in 1961. With the passing of the Land Reform Act in 1972 and the amendments introduced in 1975, 63% per cent of the total area under tea, 32 per cent of area under rubber and 10 per cent of area under coconuts were nationalised. As well there were state trading monopolies operated by a number of public enterprises by mid-1970s. The overall result was the rapid expansion of the public sector. The handful of public enterprises that existed in the early 1960s multiplied to more than 100 by the mid-1970s (Lal and Rajapathirana 1985, pp. 21-22). The size of the public sector grew at the expense of the private sector from around 10% of GDP in 1950 to about 30% in 1977 (Rajapathirana 1988, p.1146).

Import substituting industrialisation behind protective walls failed to produce the desired results. The tariff walls and import substitution industrialisation coupled with the overvalued exchange rate created a bias against export promotion and domestic agriculture. Even though industrial production increased in the 1960s, a solid enough base involving increased investment to support the growth process was not created. The main negative aspects of these policies were recurring shortages and a growing black market, reduced economic activities in most sectors and very little evidence of diversification and structural change. In sum the highly interventionist pre-1977 economic regime had a profound impact on resource allocation adversely affecting long term growth and its quality.

However there was an interesting aspect of the Sri Lankan economy which by 1970 emerged as an outstanding example of a developing country whose level of social progress was high in relation to the per capita income of the country (Grant 1978, Isenman 1980, Sen 1981, Fields 1980, Cornia et al. (eds) 1988). From independence and even before, successive governments of Sri Lanka were committed to maintaining three major social policies: a food subsidy, an entirely free education system, and a free health care service on a universal basis. The increasing welfare transfers to the population helped not only to raise real income levels and cushion the people from the impact of inflation, but also contributed to higher standards of health, medical care, nutrition and education. Thus the physical quality of life of the Sri Lankan population improved considerably as a result of these social policies. Income distribution also improved in the early 1970s as compared with that of the second half of 1960s as reflected in the Gini Coefficient (Item 15 of Table 1). However there has been considerable debate on the issue as to whether Sri Lanka's social progress in post-independence period was really an exception. Bhalla (1988) quotes his 1986 study which found, using data for the period 1960-1978, that out of the six indicators of social progress examined, for only two -life expectancy and the death rate- does Sri Lanka perform better than average. For other indicators, the country either performed better than average (fertility) or worse than average (literacy). Moreover he concludes that it is most likely that absolute poverty between 1960 and 1978 increased. But Sen (1986) has contested these results.[3] Despite the on-going debate it is generally agreed that Sri Lanka achieved considerable social progress in the post-independence period.

Sri Lanka's record achievements on the social front up until 1977 were, however, accompanied by a relatively low economic growth rate.[4] Despite the government's control over the infrastructure, industry and services, the public sector failed to initiate economic growth. As shown in Table 1 real GDP growth rate declined to 2.9% per annum on an annual average basis for the period 1971-1977 from a high of 4.0-5.4% in the decade of 1960. A similar trend is observed for per capita real GDP growth rates.

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[3] See Bhalla (1986) also.

[4] The following discussion, centered on Table 1, basically begins from 1960 for a good reason. The early 1960s mark a turning point in the history of economic and social policy in Sri Lanka since the country moved from a relatively open to a closed economy and then approached the status of a welfare state.

TABLE 1

SRI LANKA - SELECTED ECONOMIC INDICATORS : 1960-1987†

(1)	(2)	(3)	(4)	(5)
Economic Indicators	1960-64	1965-70	1971-77	1978-87
1. Economic growth (real GDP growth rate %)	4.0	5.4	2.9	5.4
2. Per capita real GDP growth rate (%)	1.5	3.0	1.3	3.6
3. Fiscal deficit (% of GDP)	5.1	5.9	7.0	13.3
4. Increase in money supply :				
Narrow (M1) (%)	6.7	3.3	16.0	16.8
Broad (M2) (%)	7.8	6.4	16.6	21.7
5. Unemployment (%)	10.5	14.0	14.7	11.7
6. Inflation [Change in implicit GDP deflator (%)]	-0.3	2.7	10.9	12.9
7. Investment (% of GDP)	13	15	16	27
8. Domestic savings (% of GDP)	11	12	13	14
9. Exchange rate - Sri Lankan Rupees per Special Drawing Right (SDR)	4.76	5.55	9.75	27.15
10. Export volume index (1985=100)	70	75	71	88
11. Import volume index (1985=100)	53	49	38	96
12. Terms of trade index (1985=100)	230	173	117	105
13. Current account deficit in balance of payments (% of GDP)	0.7	1.9	1.7	15.2
14. Debt service ratio (% of exports of goods and services)	n.a.	10.1	20.4	18.1
15. Income Distribution*	0.49	0.41	0.49	0.52

Notes :

† Annual average values for various periods are shown.
* Gini coefficient for 1963, 1973, 1978/79 and 1981/82.

Sources :

Central Bank of Sri Lanka Annual Reports and Reviews of the Economy and International Monetary Fund International Financial Statistics (various issues).

The broad-based provision of welfare services increased government budgetary expenditure as the population grew. The fiscal deficit as a percentage of GDP rose from around 5% in the 1960s to 7.0% in the 1971-1977 period. Unemployment (item 5 in Table 1) increased from 10.5% in the early 1960s to 14.7% in the pre-liberalisation period of 1971-1977 and inflation (item 6) rose from a single digit figure in the 1960s to a double-digit one in the latter period. Monetisation of budget deficits coupled with a substantial increase in money supply (item 4), reaching double-digit figures in the pre-liberalisation period, would have been the two major underlying reasons behind the high level of inflation. While the government was incapable of generating budgetary surpluses, the country's savings capacity, impaired by low per capita income, also contributed to a low rate of investment (items 3, 7 and 8 in Table 1). The country's gross domestic savings rate lagged behind investment all the time. Successive governments not only failed to generate public savings but also added more spending power by their deficit financing through bank sources financing subsidies and other welfare measures. Ultimately government policies caused higher import values and higher rates of domestic consumption, which in turn diverted domestic production away from exports, adversely impacting on the balance of payments in the process. The severity of import restrictions can be gauged by the import volume index which declined from 53 in 1960-64 to 38 in 1971-77 (item 11). Effects of the highly restrictive trade regime (1970-77) on exports is reflected in the export volume index which declined to 71 from 75 in the 1965-70 period (item 10). In the face of the overvalued exchange rate and the approximate 100% deterioration of terms of trade between 1960 and 1977 (item 12), the current account deficit on the balance of payments also deteriorated while marginally improving in the pre-liberalisation period as compared with that of the mid-1960s (item 13). The deterioration in the external sector is reflected in the debt service ratio which increased from 10.1% in the second half of 1960s to 20.4% in the immediate pre-liberalisation period (item 14).

Under these circumstances it was necessary to restrain consumption since output could not be expanded in the short run by monetary and fiscal measures. However Sri Lanka was not in a position to adopt such corrective measures to the extent required in the face of the conflicting aims of development on the one hand and stability on the other that were paramount in the minds of government policy-makers.

3.0 Policy Reforms after 1977

One of the election pledges of the United National Party (UNP) prior to the 1977 general election was to do away with the development strategy based on inward-looking trade regime, exchange controls, extensive and complicated systems of government controls on goods and factor markets. The new UNP government on assuming power in 1977 set out to implement its policies in response to the prevailing adverse economic situation. The series of liberalisation measures taken after 1977 are now well-documented and included the following :

1. The dual exchange rate was unified under the higher rate devaluing the Sri Lankan (SL) Rupee by 46.2 per cent against the US dollar to reflect closely the international value of the Sri Lankan currency. Flexibility of the exchange rate was subsequently achieved through a managed float of the SL Rupee based on a trade-weighted basket of currencies. Exchange controls on transactions on the current account of the balance of payments were abolished.

2. Trade was liberalised with the abolition of the system of import licensing in the case of 90 per cent of the Brussels Tariff Nomenclature (BTN) headings and replaced with a simplified tariff structure.

3. Policy measures were taken to attract foreign private investment including changes in the regulations governing the repatriation of profits and foreign investment licensing. Promotion of foreign investment was strengthened through the establishment of The Greater Colombo Economic Commission (GCEC) and the revamping of the Foreign Investment Advisory Committee (FIAC).

4. Domestic price controls were dismantled except for a few essential consumer goods. Most consumer subsidies were removed. The procurement price of locally produced rice was increased by 21 per cent and the system of universal food subsidies was replaced by a food stamp scheme targeted at the needy segments of society.

5. Fiscal measures were adopted to stimulate private investments in several selected areas including accelerated and lump-sum depreciation provisions and tax holidays. However successive years saw the gradual reduction of concessions available under these measures.

6. The general level of lending and deposit rates was substantially increased through the adjustment in the bank rate and the National Savings Bank interest rates. Tight controls were imposed on lending by commercial banks. Reserve requirements of commercial banks were tightened up.

7. The government launched a massive public investment programme in which the three lead projects - the Accelerated Mahaweli Programme, the Housing and Urban Development Programme and the Free Trade Zone under the GCEC - played the predominant role. With the availability of a stand-by credit facility from the International Monetary Fund, a coherent effort was made to obtain increased foreign aid to finance these three lead projects as well as other developmental activities.

The basic thrust of policy reforms initiated after 1977 revolved around the stimulation of private sector economic activity, both local and foreign, in a liberalised economic environment with supportive infrastructure investment undertaken by the government. The economy was expected to adjust itself more effectively to the changing international economic environment and to contribute to higher economic growth and employment. The major expectation was that the export sector would respond positively and show greater dynamism than in the past.

4.0 Results of the Policy Reforms

A summary of results of the policy reforms is shown in the last column of Table 1. Firstly the favourable results are examined. From an economic growth perspective the GDP growth of 5.4% for the post-liberalisation period has been an improvement over the immediate pre-liberalisation period. An impressive per capita income growth of 3.6% (item 2) was also been achieved in that time period while unemployment also declined to 11.7%, the lowest for any sub-period except 1960-64 (item 5). The level of investment increased by almost 75% over the 1971-77 period to 27% of GDP, a remarkable performance (item 7). But the domestic savings performance (item 8) improved only marginally during the post-liberalisation period. Some improvement on the debt-service ratio from the level prevailing during the period 1971-77 is also observed (item 14), but the late 1980s have recorded increasing debt-service ratios for individual years.

Secondly the unfavourable developments in the Sri Lankan economy after 1977 are dominated by very high fiscal deficits, substantially increased inflation and adverse external sector developments. The fiscal deficit as a per cent of GDP nearly doubled from 7.0% in the immediate pre-liberalisation period to 13.3% (item 3). Increases in money supply measures (item 4) were at the higher levels of 16.8% and 21.7%, partly the result of increased monetisation of massive budget deficits. Substantially increased inflation (item 6) and the devaluation of exchange rate (item 9) resulted from these adverse macroeconomic developments. While export volume increased to some extent (item 10), the import volume index (item 11) recorded a massive increase in the post-liberalisation period as compared to that of the pre-liberalisation period. The alarming deterioration of the terms of trade (item 12) since 1960, beyond the control of the Sri Lankan authorities, because Sri Lanka is still basically a primary-producing country, continued in the post-liberalisation period. The most disappointing macroeconomic development after 1977 was the all-time high current account deficit of 15.2% of GDP (item 13).

In a nutshell liberalisation moved the current account into a widening deficit while the drive for growth added further demand pressures on the economy, thus worsening the deficit. These developments made the delicate process of short-term macroeconomic management essential for long-term balance of payments adjustment and economic growth extremely difficult.

What do all these macroeconomic developments for the 1978-87 period show ? There is no doubt that the desired results of the economic policy reforms were not achieved. Were the mixed results of the liberalisation exercise due to the manner in which the liberalisation exercise was carried out ? Were the adverse developments in the macroeconomy beyond the control of the government ? In other words were there any external or internal factors beyond the control of the government ? Or did political expediency make it necessary for the government to avoid taking the required follow-up action after the liberalisation ? An attempt will be made to find answers to these questions in the following section.

5.0 An Evaluation of the Post-Liberalisation Experience

The first question that arises is whether the sequencing of the liberalisation exercise was appropriate to the economic conditions prevailing in 1977. After the 1977 election the country was undoubtedly in the mood for a change. Moreover in 1977 the country recorded a current account surplus in the balance of payments, the only one after 1965. This favourable development in the external sector was conducive to the introduction of economic reforms. There seems to be general agreement that the optimal approach to the dismantling of controls could start with current account transactions in the balance of payments and the factor markets, leaving the capital account transactions of the balance of payments subject to controls (McKinnon 1982, Krueger 1984, Edwards 1984). South Korea in 1964-65 and Sri Lanka after 1977 followed this generally agreed sequencing of the liberalisation. South Korea's liberalisation was a highly successful one, as reflected in the higher per-capita economic growth prevailing in that country. Thus there seems to have been no problem with the sequencing of the 1977 liberalisation exercise in Sri Lanka. The second issue is the speed at which controls should be dismantled (the timing). Krueger (1984) prefers rapid liberalisation. In this sense both the Korean and the Sri Lankan liberalisations were rapid.[5] In Sri Lanka, policy reforms were implemented fast beginning in November 1977 (Rajapathirana 1988). While the reforms were not carried out in a phased-out manner, the policy measures taken were simple, extensive and clearly defined at the commencement of the liberalisation process. Thus there was nothing in the sequencing and timing of the liberalisation exercise that should have hampered a favourable outcome.

[5] See Brown (1973), McKinnon's comment in Choksi and Papageorgiou (eds) (1986) and Rajapathirana (1988).

But there were weaknesses in the follow-up to the liberalisation. Immediate follow-up action was necessary if the trade liberalisation were to be successful. However such follow-up actions were taken rather slowly especially in the area of tariff reduction. By the time the tariffs were further reduced in 1985 it was too late, and even then high protection was still accorded to some 35 items produced by public enterprises. The ultimate result was an incomplete liberalisation which was outpaced by the macroeconomic crisis. Thus it would appear that there was a basic implementational problem after the liberalisation.

A cursory glance at the various liberalisation measures undertaken after 1977 indicates a basic inconsistency in that public investment was to be increased although all the other policy measures were directed at the stimulation of private investments. While the economy was being liberalised to allow the private sector to play the dominant role, the government should have restricted its own role to the minimum and generated a budgetary surplus in a consistent policy reform. This was the case in the successful liberalisation programme carried out in South Korea in the mid-1960s (Brown 1973). In contrast in Sri Lanka as announced under the policy reforms, a public investment programme was carried out after 1977 thus frustrating the liberalisation exercise.

Here an attempt is made to find out why the government was so inclined to increase public expenditure and also to analyse the evolving situation on the fiscal front after 1977. As already noted, when the UNP government came to power in 1977 it sought to achieve structural change both by liberalising the economy and by expanding rapidly the level of public investment.[6] Sri Lanka has been judged as a country highly committed to economic reforms after 1977 (Nelson 1984). The new policy reforms envisaged that the public sector would concentrate on areas which were not essential and not attractive to the private sector. The hope was that the relaxation of controls together with shifts in relative prices arising from the policy reforms, would create opportunities that would enable the private sector to transform the economy. As of 1977 this view was shared by the World Bank, other donor agencies and many analysts of the Sri Lankan economy. But the Sri Lankan government as well as the international community, i.e. aid donors deviated from the announced policy objectives.

[6] The following discussion heavily draws on Levy (1987).

A close examination reveals that the objective of the government was to provide opportunities for patronage to its supporters, especially the business and bureaucratic elites, to achieve visible economic gains in the short run, and to promote a resurgent economic nationalism. Neither liberalisation nor balanced public investment offered hope for the government to fulfil these objectives at least in the short run and medium run. Thus the government had to look for ways to fulfil these objectives. The most convenient method was the public investment programme. Even the aid donors, viewed Sri Lanka in 1977 as a democratic developing country, with the best record of social welfare in the developing world, and very much, in need of rapid expansion of project finance. This view was really in conflict with the Sri Lankan government's enunciated policy of liberalisation with a supportive infrastructure under the public investment programme. Consequently after 1977 the massive foreign aid inflow provided the Sri Lankan government with the means to push forward with the Mahaweli Scheme on a scale that worked against liberalisation and other components of the public investment programme.

In the following sections these inconsistencies in economic policy after 1977 are brought into proper perspective under two headings, i.e. imbalance in the domestic economy and the disequilibrium in the external sector.

5.1 Internal Balance and the Post-1977 Policy Reforms

By 1980 the emerging situation showed that economic conditions in Sri Lanka were deteriorating really and inexorably[7]. There were at least three aspects of fiscal policy which contributed to the degenerative economic situation after 1978. First, out of the three large projects undertaken after 1977, two - the Accelerated Mahaweli Project (the multi-purpose river basin development project) and the Housing and Urban Development Programme- increased public expenditure both in the form of investment and consumption on a massive scale. Expenditure under the Public Investment Programme more than doubled between 1977 and 1984, thus adding pressure on the limited resources at the disposal of the Sri Lankan economy (column 4 of Table 2). During 1982-84 the Mahaweli project alone was responsible

[7] This discussion draws heavily on Rajapathirana (1988).

for 44 per cent of the value of public investment. Even though the Mahaweli expenditure was largely financed by foreign borrowings, the required high level of local currency component had to be found through the government budget (Athukorala and Jayasuriya 1993). This put increasing pressure on already constrained government budgetary resources. The current expenditure of the government which was only SL Rs. 3585 million in 1973 ballooned to a massive SL Rs. 18227 million in 1982.[8]

Second the budgetary savings resulting from the reduction in the welfare subsidies[9] were more than offset by increased transfers to loss-incurring public enterprises. Efficiency improvements in the public enterprises and the privatisation of inefficient public enterprises were the talk of the day in 1978 (Central Bank of Sri Lanka Review of the Economy 1978). But the gap between the rhetoric and practice was vast during the period 1978-1987.[10] Besides the privatisation of government-owned textile mills in 1980 and 1982 and the liquidation of a few government enterprises, many other government-owned manufacturing enterprises continued to be in operation despite widespread inefficiencies and the resultant drain on budgetary resources. While preferential tariff and quota protection were provided to some of these public enterprises, a number of new public corporations such as the National Development Bank of Sri Lanka (1979), the Sri Lanka Export Credit Insurance Corporation (1979) and the National Insurance Corporation (1980) were established. By 1986 the number of public enterprises was still high at 106 (Athukorala and Jayasuriya 1993). Transfers to public corporations out of the government budget peaked at 11.6% of the GDP in 1982 (column 3 of Table 2). Thus the budgetary savings achieved through a reduction in subsidies after 1977 were frittered away on increased transfers to inefficient public corporations further contributing substantially to increased budget deficits.

Third, there were also the ethnic disturbances which, starting in 1983, contributed to rising military spending by the government. Military expenditure in the immediate pre-liberalisation period ranged between 0.6-1.3% of the GDP (column 2 of Table 2). However after 1985 military spending rose dramatically reaching 3.1% of the GDP by 1987. It also needs to be

[8] Data as quoted in Rajapathirana (1988), p.1152, Table 8 obtained from Central Bank of Sri Lanka.

[9] The subsidies which amounted to 9.6 per cent of GDP in 1977 were absorbing only 3.4 per cent in 1981 (World Bank 1982, p.9).

[10] The following discussion is solely based on Athukorala and Jayasuriya (1993).

noted that by the time the effects of the ethnic turmoil were felt after 1983, the negative consequences arising from the incompetent macroeconomic management of the 1977 liberalisation and stabilisation programme had already taken their toll on the Sri Lankan economy.

As the above discussion shows, even after the liberalisation, the management of the economy was highly centralised. The cumulative effects of the three factors discussed earlier resulted in a huge government budget deficit blow-out in the post-liberalisation period. In the immediate pre-liberalisation period the government budget deficits ranged from 4.4 to 8.2% of the GDP (column 5 of Table 2). But the post-liberalisation period witnessed massive budget deficits ranging from 12.0 to 22.2% of the GDP except for 1984. The huge cost of financing the three lead projects included in the Public Investment Programme (PIP) has partially contributed to a substantial extent to the budget deficit blow-out after 1978. Not unexpectedly as long ago as 1980, there was scepticism on the ability of the government to generate the required budgetary savings to finance the PIP (Hewavitharana 1980).

TABLE 2

SRI LANKA - SELECTED INDICATORS ON INTERNAL BALANCE : 1970-1987

(1)	(2)	(3)	(4)	(5)	(6)	(7)
Year	A	B	C	D	E	F
1970	0.7	2.2	-	6.6	6.6	0.9
1971	1.3	2.2	-	8.2	1.3	2.8
1972	1.3	2.3	-	7.7	3.0	0.6
1973	0.8	3.0	-	5.3	-14.8	16.6
1974	0.7	2.3	-	4.4	-16.3	24.2
1975	0.7	3.4	-	7.9	-3.1	7.0
1976	0.6	3.6	-	9.6	36.2	8.8
1977	0.6	2.8	100	5.8	14.1	16.0
1978	0.7	7.4	153	14.1	7.6	9.6
1979	0.8	7.7	175	14.5	14.7	15.4
1980	0.7	11.5	276	22.2	72.4	20.1
1981	0.6	8.9	205	13.1	-0.5	20.8
1982	0.5	11.6	222	17.7	7.7	11.1
1983	0.8	9.6	214	12.0	-6.2	16.7
1984	0.8	9.6	210	6.8	-32.7	21.5
1985	2.8	8.8	n.a.	11.0	40.9	1.1
1986	2.4	9.4	n.a.	11.1	3.7	5.8
1987	3.1	6.3	n.a.	10.3	-1.4	7.0

Notes :

A = Defence expenditure as a per cent of GDP.

B = Total transfers to government corporations from the budget (both current and capital) as per cent of GDP.

C = Index (1977=100) of total expenditure in Public Investment Programme as a per cent of GDP.

D = Government budget deficit as a per cent of GDP.

E = Real annual growth rate of Central Bank credit to government (%).

F = Annual rate of inflation (change in the GDP deflator) (1980=100) (%).

n.a. = Non-availability of data.

Sources :

International Monetary Fund International Financial Statistics (1989), Central Bankof Sri Lanka Annual Reports and Reviews of the Economy and Public Investment Programme (various issues).

The government in the post-liberalisation partially monetised its successive budget deficits at an increasing rate (column 6 of Table 2). The real annual growth rates of government borrowings from the Central Bank of Sri Lanka hit an all-time high of 72.4% in 1980. Even as late as 1985, the real annual growth rate of Central Bank lending to the government was as high as 40.9%. Such increasing monetisation of government budget deficits[11] contributed to a substantial extent to the high rate of inflation (column 7 of Table 2). In 1980 the rate of inflation as measured by the changes in the implicit GDP deflator recorded a large increase of 20.1% rising by a further 20.8% in the following year.

These developments on the inflation front after 1978 inevitably led to the highest ever recorded annual average rate of inflation in Sri Lanka for any sub-period, i.e. 12.9%.[12] The basic imbalances which arose in the domestic economy had some adverse effects on the welfare of vulnerable groups in the Sri Lankan society (UNICEF 1988). Very high price increases, particularly for food items and kerosene, created substantial hardships for low-income groups. Even though the decline in real wages was much less in the informal sector, it was in the organised sector where the real wage declined substantially as a result of increased inflation. As shown in the Consumer Finance Surveys, compared to 1973 (Gini Coefficient (GC) = 0.41), income distribution in Sri Lanka became more uneven in 1978/79 (GC = 0.49) and deteriorated further in 1981/82 (GC = 0.52) (item 15 in Table 1). Thus the level of progress made in the social front prior to 1978 suffered a setback in the post-liberalisation period.

5.2 External Balance and the Post-1977 Policy Reforms

As indicated earlier, the massive budget deficits in the post-liberalisation period were financed to a substantial extent through expansionary methods. These additional funds by creating a higher demand, stimulated inflation, and overflowed into a higher demand for imports. Imports of goods and services which were only SL Rs. 6290 million in 1977 reached a massive figure of

[11] Monetisation of increasing government budget deficits had an adverse impact on the interest rate reform carried out in 1977. These developments had important implications for the success of the financial reforms.

[12] Computed using data given in Table 2, column (7).

SL Rs. 61102 million by the end of 1987 (Central Bank of Sri Lanka Review of the Economy 1988, Appendix Table 82). The mediocre growth in exports was below expectations and saw the exports of goods and services increasing from SL Rs. 6640 million to SL Rs. 41097 for the same period. The result was that the current account surplus in the balance of payments of SL Rs. 1266 million in 1977 turned into a blown-out current account deficit of SL Rs. 10093 by the end of 1987. These external sector developments had a cumulative adverse effect on the external balance of the economy after 1977.

The underlying factors behind these unfavourable developments in the external sector are analysed below in some detail.[13] The initial response of the economy to the liberalisation was rather impressive in that the GDP growth rates were 8.2%, 6.0% and 5.8% for the three years from 1978 to 1980 respectively.[14] While industrial exports increased rapidly after the liberalisation, output in the manufacturing sector also recorded an increased growth rate of 10.8% in 1978 (Rajapathirana 1988). As the capital-output ratio declined, the output-labour ratio increased in the manufacturing sector resulting in increased capacity utilisation from 54% in 1974 to 74% in 1981 (Rajapathirana 1988). However after 1981 the Sri Lankan economy moved into a sluggish phase of growth.

[13] See Athukorala and Jayasuriya (1993) for succinct discussion on the crisis episode in the post-liberalisation period.
[14] Data from Rajapathirana (1988). Most of the following discussion heavily draws on this source.

TABLE 3

SRI LANKA - SELECTED INDICATORS ON EXTERNAL BALANCE : 1970-1987

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Period	A	B	C	D	E	F	G	H
1970	76	49	148	51	1.5	-0.4	+25.5	11.5
1971	74	43	139	54	0.5	-0.14	+95.5	12.8
1972	72	43	132	52	0.2	-0.14	+228.6	15.7
1973	73	38	114	59	0.2	0.01	+124.5	15.2
1974	63	27	102	67	6.7	-0.008	+37.6	12.4
1975	76	33	82	75	6.7	0.07	-54.9	13.9
1976	72	36	107	81	1.6	0.19	+568.3	16.4
1977	67	46	141	76	-4.0*	0.34	+4171.1	29.1
1978	71	63	138	105	5.0	0.8	+1903.7	34.2
1979	72	78	99	108	13.0	1.4	+2175.3	30.2
1980	75	98	91	100	25.3	3.4	-2886.1	33.5
1981	83	92	87	101	18.5	4.6	+2456.0	34.3
1982	88	90	79	96	22.5	5.5	+2011.5	34.9
1983	83	101	99	89	17.8	5.3	+1792.5	37.9
1984	97	105	122	78	8.3	4.6	+5915.3	34.9
1985	100	100	100	96	14.3	4.4	+574.1	41.7
1986	107	114	96	115	13.9	4.5	-1215.3	48.0
1987	108	117	98	n.a.	13.0	4.7	+593.0	55.9

Notes :

A = Export volume index (1985=100).
B = Import volume index (1985=100).
C = Terms of trade index (1985=100).
D = Trade weighted real exchange rate index (1980=100).
E = Current account balance as a per cent of GDP.
F = Private remittances as a per cent of GDP.
G = Movements in foreign reserves in Sri Lankan Rs. million.
H = Foreign debt of the government as a per cent of GDP.
* Current account surplus in the balance of payments.
n.a = on-availability of data.

Sources :

(a) Athukorala and Jayasuriya (1993) - Data in column 5.
(b) Central Bank of Sri Lanka Annual Reports and Reviews of the Economy and International Monetary Fund International Financial Statistics (various issues) - For all other data.

By 1980, the second oil shock had taken place and the world economy was headed into a recession. The deteriorating terms of trade and the inability to overcome the supply constraints on the tree crop sector (tea, rubber and coconuts), together with increased imports, worsened Sri Lanka's trade balance. Being a primary producing country the deteriorating terms of trade was a factor beyond the control of Sri Lankan government. However the supply bottlenecks in the tree crop sector were the result of the nationalisation of tea, rubber and coconut estates by the previous government in 1975 and the long neglect of the sector due to uncertainties arising out of subsequent government policies. Even the UNP government elected in 1977 made no effort to arrest the decline in production in the tree crop sector until mid-1980s. In the midst of these problems on the international trade front, the increased oil import prices after 1979 further contributed to the deterioration in the balance of payments especially around 1980. The current account deficit of the balance of payments as a per cent of GDP in the immediate pre-liberalisation period was always a single digit figure as compared with a double digit figure for most of the time in the post-liberalisation period (column 6 of Table 3).

A domestic disequilibrium arising from the massive public investment programme was emerging by 1981 to compound the difficulties associated with the external imbalance. Out of the three lead projects, Mahaweli Development Project and the Housing and Urban Development Programme were a drain on country's resources destined to provide only benefits in the long run. Moreover the massive investments under these two projects were not going to increase tradeable production to help the country to overcome the problems in the current account on the balance of payments. These projects essentially increased investments in the non-tradeable areas thus augmenting the imbalances in the Sri Lankan economy. The adverse effects of domestic disequilibrium arising from the massive public investment were magnified by the external shock coming from the world recession around 1981. The costs of the external shock to the Sri Lankan economy have been very high. It has been estimated that the combined cost of the external shock to the Sri Lankan economy arising from the adverse terms of trade (column 4 of Table 3), high global interest rates and reduced demand for exports (column 2) was 25% of GNP between 1979 and 1981 as compared with an average of 6% for developing countries as a whole (Balassa and McCarthy 1984).

The internal imbalance arising on the fiscal front as a result of the public investment programme coupled with very high capital inflows in the post-liberalisation period accounted for the real exchange rate appreciation between 1978 and 1981 (column 5 of Table 3). The real exchange rate appreciation is a rather surprising result for a newly liberalised economy. Generally a liberalisation of this kind results in a sharp fall in the real exchange rate, as the newly liberalised demand for imports (column 3) forces up the price of foreign exchange. The opposite happened in Sri Lanka. Even as late as 1986, the trade-weighted real exchange rate appreciated substantially. Although the real exchange rate dropped in 1984 somewhat close to the level prevailing in 1977, most of the post-liberalisation period witnessed a level well above the 1977 level. Clearly, the appreciation of the real exchange rate between 1978 and 1987 contributed partly to Sri Lanka's declining export performance. Both inflation (column 7 of Table 2) and the current account deficit as a per cent of GDP (column 6 Table 3) reached double digits most of the time between 1978 and 1987. The only favourable development from the current account point of view at this time was the massive increase in migrant remittances which reached the peak of 5.5 per cent of GDP in 1982 (column 7 of Table 3). But such increased remittances would also have partly contributed to the real exchange rate appreciation (Lal 1985). In 1981 for the first time after the liberalisation Sri Lanka's external assets fell by SL Rs. 2886.1 million (column 8 of Table 3). The external reserves fell once again by SL Rs. 1215.3 million in 1986, a clear reflection of the worsening economic situation. The alarmingly low level of the external assets position was revealed when Sri Lanka had external assets only to the value of 0.23 billion US dollars, worth only 1.3 months of imports (1.3 months' import cover) at the end of 1988 (The Economist 24/06/1989, p.110). The final result of all these adverse external sector developments was the massive accumulated foreign debt burden which exceeded 50% of the GDP by the end of 1987. Thus in years to come the country faces with a very heavy debt service problem (column 9 of Table 3).

6.0 A Post-Script on Post 1977 Economic Policy Reforms

At independence in 1948, Sri Lanka had an open economy with a neutral trade regime. After 1960 the economy changed course and a restrictive trade regime came into being. Successive governments, committing themselves to the welfare state, did not apparently want to follow an outward-oriented strategy. Between 1970 and 1977 under the country's ever more restrictive economic regime a serious attempt was made to diversify exports. But such attempts were not fruitful because of the prevalent bias against exports in general, and the inefficiencies arising from the restrictive trade regime and other controls in particular. Despite the progress made on the social front, by 1977 the Sri Lankan economy was at a low ebb, with pervasive shortages of essential items required for day-to-day living.

The government elected in 1977 was committed to economic reforms and in a relatively short period of time it liberalised the economy extensively. However these reforms, while promoting a high growth of GDP and employment, failed to remove some long-standing structural weaknesses in the economy as reflected in the balance of payments. The adverse changes in the external sector were manifested in the trade account in respect of both commodity imports and exports. A principal cause of the disequilibrium in the external sector was the lack of commitment to manage a viable government budget as a result of the massive public investment programme undertaken after 1978. The authorities were unable to cope with the consequent inflationary pressures and the flow-through effects on external equilibrium in the form of the real exchange rate appreciation. Despite policy statements to the effect that Sri Lanka was embarking upon a new export-led growth strategy in 1977, neither the real exchange rate movements nor the resulting mediocre export performance paints a favourable picture of an economy where such policy reforms have actually taken place.

The outcome of the liberalisation was bound to be diametrically opposite to expectations since it left an *unfinished agenda* (Rajapathirana 1988). The necessary follow-up actions after the liberalisation were either never taken or taken rather late[15] thus frustrating the whole exercise. Follow-up actions were needed to reduce the variance in rate of effective protection[16] to create

[15] See next footnote.
[16] However the 1988 Budget announced a new four-tier tariff structure with a maximum tariff of 50%.

a more neutral trade regime. It was necessary to abolish licensing requirements for 281 imported items and also to maintain a realistic exchange rate to be competitive in international markets. Further liberalisation of the domestic capital market, opening the capital transactions of the balance of payments and relaxation of restrictions placed on private direct foreign investment also formed part of the *unfinished business*. Moreover action was necessary on persisting rigidities in the Sri Lankan labour market such as minimum wage standards, limits to firing employees and social security legislation. However doubts arose as to whether a government incapable of taking necessary adequate follow-up actions on the reforms already put in place, can effectively carry out further reforms.

Since 1985 real economic growth slowed down as both direct and indirect repercussions of civil disturbances in the country percolated through the economy. These disturbances exacerbated the impact of domestic structural imbalances and unfavourable external factors. Some attempts by the government, with the help from international agencies, to stabilise the economy and bring about structural adjustments were thwarted by the government's own failure to cut overall expenditure and contain the budget deficits, especially because of escalating expenditures on defence and internal security. As of this writing the Sri Lankan economy is burdened with a massive foreign debt and faced with bleak and dismal prospects. The liberalisation exercise could not achieve the desired results on important areas in the economy.

But it was a rather belated measure. Such a tariff structure should have been announced in the late 1970s to reap the benefits of trade liberalisation.

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