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A MACROECONOMIC OVERVIEW OF SRI LANKA 1970-87
With Special Reference To Stabilisation Issues

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CONTENTS

I. GROWTH AND COMPOSITION OF THE DOMESTIC PRODUCT.....2

II. AGGREGATE SUPPLY AND DEMAND.....4

III. INVESTMENT AND SAVINGS.....8

IV. THE BALANCE OF PAYMENTS.....13

V. PUBLIC FINANCE.....18

VI. INCOME AND EMPLOYMENT.....25

VII. PRICE MOVEMENTS AND MONETARY GROWTH.....27

VIII. CONCLUSIONS.....31

NOTES.....33

REFERENCES.....37

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For purposes of understanding the evolution of the macroeconomy of Sri Lanka in the period since 1970, it is useful to divide the 18-year period 1970-1987 into two sub-periods, the dividing line being drawn at 1977. At this point, a number of far-reaching economic policy reforms were introduced. A definite acceleration of economic growth and a general improvement in economic activity followed these economic policy reforms. For most macroeconomic variables 1977-1978 appears to be a point of departure from the old trend. See for example Charts 1 and 2.

However, together with these changes and also as a consequence of other elements in this reform package, the overall balance between supply and demand for resources became suddenly disturbed; so much so that, in the period since 1981, the restoration of economic stability became a major policy objective. A question that naturally arises concerns the trade-off between growth and economic stability. A closer analysis of the movements of the various macroeconomic variables may provide useful insights into the nature of this trade-off in the case of Sri Lanka and, consequently, may help to draw some lessons for the future.

The approach in the present paper will be basically one of examining the movements of the major macroeconomic variables in the two periods. The emphasis will be on the identification of similarities and differences between the two sub-periods and on the nature of common or invariant factors.

The paper is presented in 7 sections as follows: (1) Growth and Composition of the Domestic Product; (2) Aggregate Supply and Demand; (3) Investment and Savings; (4) The Balance of Payments; (5) Public Finance; (6) Income and Employment; (7) Price Movements and Monetary Growth.

I. GROWTH AND COMPOSITION OF THE DOMESTIC PRODUCT

In the period reviewed, Sri Lanka's economy achieved a rate of growth higher than that of the population by a comfortable margin so that her people were able to enjoy a gradually rising standard of living. Table 1 below compares the overall growth performance of the Sri Lankan economy with those of a number of country groupings for selected periods. It may be noted that Sri Lanka's economic growth has been slightly slower than the average of all developing countries in the 1965-80 period. In the eighties, the country was able to reach the average growth rate of Low Income Asia, and thus exceed the Developing Countries' average.

Thus, generally speaking, Sri Lanka's economic growth has kept pace with the rest of the developing world. However, the emergence of an unemployment problem which has reached crisis proportions, strongly suggests a divergence between what was actually achieved and what would have been desirable in the context of demographic and socio-economic developments in the period.

Table 1
Growth Rates of GDP 1965-1987
Sri Lanka Compared with Groups of Countries

	Industrial Market Economies	Developing Countries	Low Income Asia	Sri Lanka
Average 1965-1973	4.5	6.5	5.9	4.1
Average 1973-1980	2.8	5.4	5.0	4.8
Average 1980-1986	2.5	3.8	5.0	5.0
1981	1.9	3.4	n/a	5.8
1982	-0.6	2.1	5.7	5.1
1983	2.3	2.1	8.6	4.9
1984	4.6	5.1	10.2	5.0
1985	3.0	5.1	8.3	5.0
1986	2.7	4.7	n/a	4.3
1987	2.6	3.0	n/a	1.5

Sources: 1. The World Bank: World Development Reports, 1987 and 1988 Annual Report 1986
2. Central Bank of Sri Lanka: Annual Reports and Reviews of the Economy, relevant issues.

The average rate of growth [1] of the Gross Domestic Product (GDP) in the 18-year period (1970-87) has been about 4.7 per cent per annum. However, this growth has been far from uniform. The pre-1978 period (sub-period 1) recorded an average growth rate of 3.0 per cent while the latter period (1978-87 or sub-period 2)

recorded an average of 5.0 per cent. Even within these two sub-periods, considerable differences between individual years are seen. Of particular importance is the initial year of sub-period 2, during which the GDP growth reached a peak of 8.2 percent.

National income data indicate that the changes in the composition of the GDP, that accompanied its growth, have not been very large. The share of value added in commodity production (Agriculture, Industry and Construction) has remained close to 54 percent of the GDP during the entire 18-year period (see Table 2) while the services (Trade, Utilities, Financial Services, Public Administration and Defence, Personal Services and other services) accounted for the balance. Even within commodity production, the relative positions of Agriculture and Industry were stable, while construction gained somewhat, mainly at the expense of services.

Table 2
Sectoral Composition of GDP at Current Factor Cost Prices

Sector Grouping	Selected Years (Percentages)				
	1970	1975	1980	1985	1987
1. Agriculture, Forestry, Hunting & Fishing	28.3	30.4	27.6	27.6	27.0
2. Industry, including Mining & Quarrying	17.4	21.8	19.7	17.0	18.8
3. Construction	5.6	4.0	8.9	7.8	7.3
Sub Total : Commodity Production	51.3	56.2	56.2	52.5	53.1
4. Services	48.7	43.8	43.8	47.5	46.9
GDP	100	100	100	100	100
GDP at f.c. Rs. Million	13187	25691	62246	163713	177731

Sources: Central Bank Annual Reports, various issues

The sectoral composition of the GDP in constant prices indicates a more pronounced decline in the relative position of Agriculture and a very small improvement in Mining and Manufacturing. As a result, the commodity producing sectors, as a group, occupied a slightly lower relative position. i.e., 49 percent. However, comparison over time in terms of constant prices has to be read with some caution, because two different series are involved, which means that certain changes in coverage and definitions have been introduced. Even if some allowance is made for possible errors on this account, there is the indication that the relative share of agriculture has declined.

Available data on employment by Industry Major Divisions [2] suggest a more significant change in composition. For example, between 1971 and 1981, the

proportion of employed population in agriculture declined from 50.1 percent to 45.5 percent, while that of industry increased from 9.7 to 10.7 percent. The proportions in construction as well as the services show similar improvements. This movement, involving a shift away from primary production to secondary and tertiary activities, is perhaps the normal structural change that is expected in a situation of rising real per capita income. The fact that values based on national income do not reflect such changes adequately can be explained either by changes in relative prices or by deficiencies in the data. Therefore it may be safe to accept that a change in composition of GDP did indeed take place as broadly suggested by the employment data. Furthermore, this conclusion is consistent with the idea that commodity production, particularly agricultural production, remains the main economic activity of the country. There is also evidence that the "growth sectors", namely Services and Industry were typically producing higher per capita incomes, the Services consistently doing much better than both Industry and Agriculture in this regard. [3]

II. AGGREGATE SUPPLY AND DEMAND

According to National Accounts data, the total supply of goods and services in the economy increased at an average annual rate of about 4 percent in the 17-year period. However, the two sub-periods differed widely in this respect. In the first sub-period (1970-1977) the average rate was slightly below the rate of growth of population, while in the latter sub-period it exceeded it by almost 4.4 percent.

Table 3 indicates a general acceleration of the flows of domestic goods and services as well as imports in sub-period 2, in contrast to sub-period 1, where a slow growth in domestic production was accompanied by a considerable decline in imports. The reversal in this declining trend in imports was perhaps one of the factors instrumental in the stimulation of economic activity in sub-period 2. A pronounced change in favour of imports of intermediate and investment goods was an indication of a strong interdependence between imports and domestic production.

Table 3
Components of Aggregate Demand and Supply in the Two Sub-Periods

	Average Growth Rates Constant 1970 Prices			Contributions to Overall Increases (percentages)		
	1970-77	1977-87	1970-87	1970-77	1977-87	1970-87
1.Private consumption	4.0	5.4	5.0	56.4	57.0	56.9
2.Public consumption	-2.1	6.5	2.8	5.0	7.5	7.2
3.Gross Domestic Capital Formation	0.2	7.5	4.4	9.0	18.5	17.4
4. Exports	1.2	5.9	4.1	29.6	17.0	18.5
Memorandum Items						
GDP	3.0	5.0	4.7	76.3	73.0	73.4
Imports	-5.9	8.6	5.5	23.7	27.0	26.6
Total Supply = Total Demand	1.2	6.0	4.0	100	100	100
Population	1.6	1.6	1.6	-	-	-

Source: Central Bank of Sri Lanka, Annual Reports and Reviews of the Economy, relevant issues.

It appears that throughout the 18-year period, the share of consumer goods in total imports declined rather rapidly (Table 4). What could be the explanation? One important reason was the increase in domestic production of food, particularly rice. The drop in commodity prices in the international markets, which resulted in cheaper food imports, would be another reason. However, a shift of this magnitude would not have occurred if the overall volume of imports itself did not expand rapidly as a result of the increase in the country's import capacity in sub-period 2.

Both categories of imports -- intermediate goods, and investment goods -- increased their respective shares in total imports. The share of investment goods increased steadily from the relatively depressed levels of sub-period 1 to reach a peak of 27.6 percent in 1982, after which it dropped sharply. On the other hand, the share of intermediate goods appears to have increased to a level which is likely to be maintained for some time. There were two important factors underlying the latter change -- the sharp increase in the real price of petroleum in the 1970s, which caused a considerable increase in the value of petroleum and allied products, and the emergence of an export-oriented garment industry which caused an increase in the volume of raw material imports.

Thus the overall supply picture was one where locally produced as well as imported goods and services were more abundant in sub-period 2. The shift in favour of intermediate and investment goods, however, did not lead to a significant reduction in the direct import content of private consumption because the volume of all imports increased in absolute terms.

Table 4
Changing Composition of Imports

	1970	1973	1976	1979	1982	1985	1987
	As Percentages of Total Merchandise Imports						
Part a							
1. Consumer Goods	55.4	52.4	36.4	32.0	16.0	26.4	36.3
2. Intermediate Goods	20.0	30.0	48.7	43.2	56.1	47.2	43.6
3. Investment Goods	23.6	16.6	13.8	24.2	27.6	19.2	18.8
4. Unclassified Goods	1.0	1.0	1.1	0.6	0.3	7.2	1.3
Total	100	100	100	100	100	100	100
Part b							
1. Consumer Goods Excluding Textiles and Clothing	50.1	50.4	35.3	27.8	15.4	19.4	22.9
2. Intermediate Goods Excluding Textiles Clothing, and Petroleum	17.5	19.2	23.6	23.2	22.3	26.9	29.2
3. Textiles and Clothing	5.4	2.0	1.0	6.8	5.2	7.0	13.4
4. Petroleum	2.5	10.9	25.1	17.4	29.3	20.3	14.5
Part c							
1. Food	46.2	48.9	36.7	22.6	12.7	16.0	15.6
2. Food Other than Wheat Grain	45.7	45.9	33.0	21.3	8.5	10.9	12.4
	Volume, Thousand m.t.						
Part d							
1. Rice	534	344	419	212	174	211	113
2. Wheat Grain	55	83	130	112	495	655	578
3. Wheat Flour	377	371	381	466	-	-	-
4. Sugar	244	194	46	245	134	388	376
5. Crude Oil Ml. Bbl.	13.3	12.8	10.7	10.5	14.2	12.2	13.1

Source: Central Bank of Sri Lanka : Annual Reports and Reviews of the Economy, relevant issues

In the period under review, the change in the composition of Sri Lanka's imports was also associated with changes in the direction of trade. In the early 1970s, countries such as China, Pakistan, India and the USA were the major suppliers of imports. It was already noted that purchases during the period were largely food and other consumer items. In recent years, however, i.e. in sub-period 2, Japan, the former Federal Republic of Germany, Iran and Indonesia emerged as the major suppliers, indicating a change in the supply mix in favour of manufactured goods, including complex equipment, building materials, and petroleum.

Given that the particular pattern of growth observed was closely related to, if not the outcome of, the evolving interaction of supply and demand factors, it may also be useful to examine the salient features of such demand factors. Of particular relevance in this regard is the openness of the Sri Lankan economy. The size of Sri Lanka's foreign trade, relative to GDP, is high even by international standards. The conventional openness indicator, (IMP+EXP)/GDP, has been about 58 percent in the

period reviewed, which makes the Sri Lankan economy more open than most countries in the Asia Pacific region, the exceptions being Singapore and South Korea.

Obviously, the more open an economy is, the less is the correspondence between the composition of demand and the composition of domestic production. This is the qualitative aspect. One may ask the question, whether the volume of domestic production has responded adequately to the changes in demand? Table 3 represents an attempt to identify the movement of some of the more important demand factors.

One of the very basic factors underlying the change in the size and composition of domestic demand was the population. Sri Lanka's population has been growing at a more or less uniform rate of about 1.6 percent per annum. This means a cumulative increase of about 31 percent in the 18-year period during which there has been a slight change in the age composition in favour of the older groups. Even though this may have affected the composition of demand, the implications are not taken up in the present discussion. Growth of per capita private consumption combined with the growth of population would have exerted the strongest influence on the growth of overall demand, on account of its volume. In current price terms private consumption contributed about 57 percent to the overall growth in demand.

Public consumption in real terms, declined in sub-period 1 and increased sharply in sub-period 2. However, the relative effect of these two movements was that its size relative to the GDP, in 1987, was still lower than what it was in 1970. Its contribution to overall increase in demand in the 18-year period was 7.2 percent. Public consumption is usually estimated as the sum of wages and salaries of government employees, and purchases of current goods and services. Therefore, the sharp upward movement in the latter period could be attributed to the growth of defence expenditure, increase in wage rates of government employees, and increases in the costs of operation and maintenance of government-owned assets.

Gross Domestic Capital Formation (GDCF) also followed a path similar to that of public consumption, i.e. there was a very slow or neglegible movement in sub-period 1 and a sharper upward movement in sub-period 2. Typically the contribution of GDCF to the total increase in demand was higher than that of public consumption. Large public outlays in power, irrigation and urban development were the major cause of this

sharp increase. There is evidence that the private sector also contributed to this surge of investment activity, albeit on a modest scale.

Growth in exports was also an important factor that affected growth in demand. Exports of goods and non-factor services measured in constant prices grew at an average rate of 5.9 percent in sub-period 2 as against a very modest rate of 1.2 percent in sub-period 1. Growth of exports in the latter period was associated with a very significant change in favour of non-agricultural exports. Measured in current SDR, the share of non-agricultural exports increased from 22 percent in 1978 to 58 percent in 1987. Thus the increased demand for exports would have arisen mainly in the non-traditional markets, particularly in respect of textiles and garments. As a consequence of this, the USA has emerged as the leading partner in Sri Lanka's export trade in place of Pakistan and China, which occupied similar positions in the 1970s.

Thus the overall position is one in which there was a considerable stimulation of demand in the second sub-period leading to a sharp divergence between domestic production and domestic absorption. Chart 1 is a graphical representation of what occurred.

III. INVESTMENT AND SAVINGS

It was shown in Table 3 that Gross Domestic Capital Formation grew at an average rate of 4.4 percent per annum in the 18-year period, but that the average rate for sub-period 2 exceeded that of sub-period 1 by a large margin. This growth was by no means uniform. Of particular significance was the steep rise of over 41 percent per annum in the 1977-80 period after which it actually declined in the 1982-87 period.

The higher rates of economic growth in the latter period were undoubtedly connected with this accelerated investment activity. Therefore, it may be useful to examine whether there were any quantifiable differences in the efficiency of investment in the two sub-periods. This is particularly relevant since it is known that there were noticeable qualitative differences in the investment projects undertaken in the two periods. They also differed somewhat in the mode of financing.

Table 5 presents two sets of Incremental Capital Output Ratios (ICOR) calculated using slightly different but basically simple methods. The Implicit ICOR (Row 2) derived from the Investment /GDP ratios at current prices, assuming no lag between investment and incremental output, suggests that there was a decline in marginal efficiency of investment in the latter sub-period. If this was actually the case, it can perhaps be attributed to the fact that most infrastructure projects undertaken by the government, which dominated the overall investment activity in this period, were of long gestation in nature and therefore would have resulted in a high implicit ICOR. On the other hand, the overall ICOR derived from a constant (1970) price series, assuming a one-year lag (Row 3), indicates that the marginal efficiency of investment was almost identical in the two sub-periods. If this was in fact true, the higher ICOR derived earlier was the result of an error caused by a combination of a price effect and a misspecification of the lag. There have been other studies [3] based on constant price data from the Department of Census and Statistics National Accounts series which suggest broadly similar results, i.e. that there were no large differences in the marginal efficiency of investment in the two periods. However, it is very likely that a much more complex relationship than a Simple Accelerator model is required to explain the movements of the incremental output in the present case. Therefore, the answer to the question concerning the efficiency of investment must remain inconclusive for the present.

Table 5
Investment and Savings Indicators [a]

Percentages, except in the case of the two ICORs

	Average		
	1970-77	1978-87	1970-87
1. GDCF/GDP at Current Prices	15.8	25.9	24.6
2. ICOR, Estimate 1 [b]	4.8	5.6	4.9
3. ICOR, Estimate 2 [c]	4.7	4.6	4.7
Constant Price Terms			
4. Domestic Savings/GDP	13.4	13.4	13.4
5. Domestic Financial Savings/GDP	2.5	4.2	4.0
6. National Savings/GNDP [d]	12.9	15.5	15.2
7. Domestic Savings/GDCF	84.7	52.0	54.8
8. National Savings/GDCF	81.4	61.3	63.0

Sources: Central Bank of Sri Lanka: Annual Reports, Reviews of the Economy, Monthly Bulletins, relevant issues.

Notes: [a] Based on the Central Bank's national income data
[b] Arithmetic mean of ICOR's of individual years. These are calculated as (I/Y)/gr, where I=GDCF, Y=GDP mp and gr=real growth rate. No lag is assumed.
[c] (Sum of I(t), t=0 to n)/(Y(n+1) - Y(0)] Where I(t) = GDCF in Year t; Y(n) = GDP in year n
[d] GNDP or Gross National Disposable Product defined as GDP+NFI from abroad+Net Private Inward Transfers.

A further aspect of capital formation that has a bearing on the long-term impact is its sectoral break-down. There are serious data problems encountered here, particularly when a classification by sector of destination is attempted. The following table (Table 6) is based on and is an update of a classification shown in [3] where the Department of Census and Statistics (DCS) data for the years 1975 to 1986 is used. It may be important to note that sub-period 1 is represented only by a 3-year series while sub-period 2 is represented by a 9-year series.

Table 6
Average Composition of Gross Domestic Fixed Capital Formation

Percentages

	1970-77	1978-86
(a) Agriculture	18.0	16.9
(b) Mining and Manufactures	25.6	16.3
(c) Construction and Services	56.4	66.7
Total	100.0	100.0

Source : Department of Census and Statistics
Note: Calculated at current prices

The selected classification suggests that the share of fixed capital formation in Services and Construction activities increased sharply in the second sub-period at the expense of the share going into Mining and Manufacturing, (to a larger extent), and that going into Agriculture, (to a lesser extent). As mentioned already, large investments in power, transport and urban development in the second sub-period explain this shift. This trend is generally consistent with the movement of sectoral shares in GDP discussed earlier. The capital formation classified by type of capital assets, shown in the table, also conforms to this trend in that a major asset created in sub-period 2 was buildings and other structures.

The observed aggregate savings in the economy can be regarded as being determined by two sets of factors. Firstly there are what may be called the structural factors which add up to the long-run propensities to save / consume. The second set of factors is basically those that cause the short-term variations of the savings ratio around its long-term trend. The latter includes changes in the general price level, income, and fluctuations in foreign trade.

In Sri Lanka, the Average Domestic Savings Ratio has changed little despite the sweeping changes that have occurred in the case of other major macroeconomic

variables. This suggests a somewhat stable Marginal Propensity to Save (MPS). A simple regression analysis [4] of the relationship between aggregate consumption and the GDP in the 18-year period yields a short-run Marginal Propensity to Consume of .867. Thus the corresponding MPS would have been .133. A similar estimation of the long-run MPS yielded the value 0.129. In fact, it appears that for this period approximately:

Long Run MPS = Short Run MPS = Short Run APS (Average Propensity to Save)

It must be mentioned, however, that this long-run stability of the Average Propensity to Consume (APC) is not a feature peculiar to Sri Lanka. It has been observed in some of the developed economies. However, for a developing country, this feature has certain disturbing implications for the prospect of achieving higher rates of growth and hence is likely to be of concern to policy in the period ahead. The observed Average Savings Ratio in Sri Lanka has been higher than that of a number of developing countries of the South Asian Region even though it was grossly inadequate relative to the investment requirements of the country. It is generally believed that income distribution is one of the important factors that influence this ratio in the long run. In the period under review there has been a shift in incomes to the higher income groups and away from the middle income groups. There is no evidence however that the shift has made any difference to the overall savings ratios.

Statistically, a large number of middle- and low-income households appear to be habitual dissavers. If this is in fact the case, any change that makes their relative position worse, such as a high rate of inflation, should reduce their contribution further and thus cancel out whatever increased saving the high income groups make. This may be one explanation to the feature noted earlier of unresponsiveness of savings to changes in income distribution. Household savings is perhaps the most important component of aggregate savings in Sri Lanka. One study on national balance sheets and flow of funds for Sri Lanka [5] commented on the dominant position of the household sector in the ownership of financial assets.

There are no studies available which help to establish any precise impact that the short-term factors mentioned earlier might have had on the movement of aggregate savings. It is yet possible to surmise that the Average Savings Ratio was influenced, to a very important extent, by such variables as Exports/GDP and the

growth rate of GDP itself. It is however noteworthy that the Average Savings Ratio had no correlation at all to movements of either the market (deposit) interest rate or the corresponding real interest rate. The explanation is perhaps found in the fact that the share of financial savings is not large enough to affect the overall movement of the Domestic Savings aggregate (see Table 5). Thus, in the 18-year period, financial savings averaged about 4 percent of GDP [6].

However, it was not possible to establish statistically any causal factors that determined the behaviour of financial savings either. Among the important short-term factors that are regarded as being relevant are the real interest rate on deposits and the rate of inflation. A straightforward statistical analysis of data for the period 1970-87 did not suggest any correlation to the variable (SF/GDP) of either of these factors. The real interest rate fluctuated widely and did not show any positive correlation. Further, the time series of SF/GDP when graphed displays a bulge precisely at the time when the various inflation indicators underwent a very sharp upward movement. Thus, instead of a negative correlation that might have been expected, overall, one finds a weak positive relationship between financial savings and inflation. Further work is required to form any conclusion in this regard. It is very likely that the phenomenon is connected with monetary growth rather than with a growth of real savings.

It may be appropriate to consider also the movement of the National Savings variable over this period. By definition, National Savings include the net inward Private Transfers and net Factor Incomes from abroad. Since the Gross National Disposable Product (GNDP) is the national income aggregate that includes all these elements, it is perhaps more appropriate to use it as the denominator for obtaining the National Savings Ratio, than the GDP, as is commonly done. The ratios shown in Table 5 were obtained in this manner. Unlike the Domestic Savings Ratio, the National Savings Ratio shows an improvement of 2.6 percentage points between the two sub-periods. The improvement comes primarily from the sharp increase in the inward Private Transfers in the Balance of Payments. As far as the availability of investible resources is concerned, such transfers have the same effect as domestic savings in that they do not add to the country's external debt. Indeed their availability in such volume proved to be very fortuitous in the difficult external payments situation. Obviously, their movements did not reflect any structural changes in the domestic economy, and for this reason the National Savings Ratio may not be as revealing as the Domestic Savings Ratio, of the underlying savings propensities of the economy.

IV. THE BALANCE OF PAYMENTS

It will be useful to view Sri Lanka's external transactions in the light of the changes that occurred in the domestic economy. The preceding discussion has suggested that one of the key differences that had an impact on the balance of payments was the manner in which a balance between supply and demand for resources was achieved. In sub-period 1, domestic absorption (i.e. Consumption + GDCF) exceeded the GDP by about 2 percent. This amounts to a self-reliance of a high order. However, in sub period 2, the excess was about 12 percent -- a rate indicative of extreme dependence. How did this abrupt change occur?

Chart 2 and Table 7 show the movements of the different current balances relative to the GDP in the 17-year period. It is seen that over the period merchandise trade dominated the movements of all external current balances. However, in the period after 1980 there has been a slight diversification in that the private inward transfers and factor service debits had begun to assume greater importance.

It is significant that the minimum point of each graph appears just 3 years after the maximum point. This abrupt drop between 1977 and 1980 marks the transition from a tightly controlled trade and exchange regime to a relatively liberal regime referred to in the earlier sections. However, it would not be correct to attribute the entire deterioration to the policy reform. A large unfavourable movement in the terms of trade and an increase in the volume of imports induced by an ambitious public investment programme also contributed to this development.

In sub-period 1, when the GDP growth was a low 3 percent per annum, the current account deficit remained at a manageable 3 percent (before grants) of GDP. In sub-period 2 a GDP growth rate of 5 percent was associated with what is clearly an unmanageable average deficit amounting to 10.5 percent. This suggests, *inter alia*, a rather high output elasticity of imports -- a structural characteristic that appears to have persisted amidst the significant changes of the past decade.

Table 7
Analysis of External Balances and Price Movements

	Percentages								
	1970	1973	1976	1979	1982	1985	1987	1970-77	1978-87
[A] External Balances /GDP In current Prices									
1. Goods & NFS	-3.2	-1.2	-2.3	-12	-19	-12.2	-10.1	-2.7	-12.9
2. Current Account	-4.8	-2.2	-2.9	-11.1	-15.4	-9.9	-7.8	-3.6	-10.5
3. Basic	-1.9	1.5	3.3	-0.5	-0.9	-1.4	-1.5	1.3	-0.4
4. Overall	1.1	2.4	3.1	1.3	-0.4	-1.9	-1.4	1.7	-0.2
In constant 1970 prices									
1. Goods & NFS	-3.2	5.6	9.6	-1.1	-0.3	-1.6	-0.3	3.8	-1.2
[B] Price Indices Change over Previous Year [a]									
1. Exports SDR terms	n/a	7.4	1.1	5.7	-3.7	-16.3	0.1	8.6	1.5
2. Imports SDR terms	n/a	26.6	16.3	10.8	2.7	2.3	-2.7	16.1	1.6
3. Terms of Trade	n/a	-15.2	-13	-4.7	-6.3	-18.1	2.8	-6.4	-0.1
4. GDP Deflator	n/a	16.4	10.3	15.5	11.0	0.7	8.0	11.8	12.6
5. Consumer Prices (CCP)	5.9	9.7	1.2	10.8	10.8	1.5	7.7	5.7	12.4
[C] Nominal Exchange Rate Change over Previous Year [a]									
1. Rs per US$	0.0	3.7	18.7	-0.3	8.2	6.8	5.1	5.9	12.7
2. Rs per SDR	0.0	13.6	15.3	2.8	1.4	5.9	15.8	8.3	13.8

Source: Central Bank of Sri Lanka, Annual Reports and Reviews of the Economy, relevant issues.
[a] Except in the last two columns where the figure represents the Least Square trend rate.

Table 8 and Chart 3 attempt to identify broad categories of capital inflows and their movements. It may be observed that such inflows rose sharply in the period after 1980. It was significant that most such inflows consisted of long- and medium-term borrowings and official transfers. Of the former, a high percentage consisted of Official Development Assistance (ODA) on highly concessionary terms.

Medium- and long-term borrowings by the private sector (which included public corporations and the government-owned business undertakings) appear to have increased substantially in sub-period 2, but they showed a tendency to fluctuate. This suggests that an important part of these borrowings were of the 'accommodating' category. Even though modest in scale, the inflow of Direct Foreign Investment (DFI) was also an important new development which reflected the success of promotional policies followed in sub-period 2.

Table 8
Balance of Payments - Summary Capital Accounts

SDR Million
Percentage of GDP within brackets

	1970	1973	1976	1979	1982	1985	1987	Average 1970-77	Average 1978-87
1. Current Account Deficit	71.0	32.0	55.0	288.0	663.0	582.0	404.0	60.9	454.7
	(4.8)	(2.2)	(2.9)	(11.1)	(15.4)	(9.9)	(7.8)	(3.6)	(10.5)
2. Financing									
(a) Official Transfers	12.0	11.0	50.0	111.0	147.0	172.0	139.0	31.4	136.7
	(0.8)	(0.7)	(2.7)	(4.3)	(3.4)	(2.9)	(2.7)	(1.8)	(3.2)
(b) Government Borrowing (Gross)	65.0	76.0	128.0	167.0	304.0	342.0	265.0	102.1	281.5
	(4.4)	(5.2)	(6.8)	(6.4)	(7.0)	(5.8)	(5.1)	(6.0)	(6.5)
(c) Government Repayments	33.0	32.0	60.0	46.0	67.0	72.0	112.0	47.6	71.5
	(2.2)	(2.2)	(3.2)	(1.8)	(1.6)	(1.2)	(2.2)	(2.8)	(1.7)
(d) Direct Foreign Investment	-	-	-	36.0	58.0	25.0	45.0	-	33.3
	(-)	(-)	(-)	(1.4)	(1.3)	(0.4)	(0.9)	(-)	(0.8)
(e) Other Private Sector Receipts (Net)	-1.0	-1.0	-1.0	7.0	182.0	33.0	-10.0	-3.6	57.1
	(-0.1)	(-0.1)	(-0.1)	(0.3)	(4.2)	(0.6)	(-0.2)	(-0.2)	(1.3)
(f) Short Term Borrowing (Net)	25.0	14.0	4.0	-	-	-	30.0	4.1	2.2
	(1.7)	(1.0)	(0.2)	(-)	(-)	(-)	(0.6)	(0.2)	(0.1)
(g) Errors and Omissions	7.0	-1.0	-7 .0	36.0	21.0	-29.0	-25.0	-1.3	5.1
	(0.5)	(-0.1)	(-0.4)	(1.4)	(0.5)	(-0.5)	(-0.5)	(-0.1)	(0.1)
(h) SDR Allocation	13.0	-	-	12.0	-	-	-	4.1	3.6
	(0.9)	(-)	(-)	(0.5)	(-)	(-)	(-)	(0.2)	(0.1)
3. Overall Balance	-	-	-	-	-	-	-	-	-6.7
	(-)	(-)	(-)	(-)	(-)	(-)	(-)	(-)	(-0.2)
GDP at Current Market Prices in SDR (Million)	1482	1468.8	1881.7	2602.4	4318.5	5876.8	5163.3	1706.9	4316.5

Source: Central Bank of Sri Lanka, Annual Reports and Reviews of the Economy, relevant issues.

One important difference between the two sub-periods is the increased diversity of capital inflows in the latter period. Within the broad category of borrowing, the medium- and long-term loans which used to be almost exclusively ODA, gave way to a mix of ODA and commercial loans in the latter sub-period. Sub-period 1 was characterised by a relatively stable balance of payments. There was a significant accumulation of gross external reserves. A modest but steady flow of concessionary capital, as well as the sudden improvement of export earnings in the year 1977, contributed to this accumulation. Thus, at the end of 1977, the external debt outstanding amounted to SDR 704.8 million which was equivalent to 32.5 percent of GDP. About 80 percent of this debt was on account of ODA. This state of affairs contrasts with sub-period 2, in which the average current account deficit of 10.5 percent of GDP resulted in a massive depletion of reserves [7] and a greatly increased external indebtedness. During this period, the share of ODA in the total debt dropped to about 74.4 percent, the balance being debt owed to commercial lending institutions. The debt on floating rates of interest also increased from zero to about 9 percent of the

total. The external debt/GDP ratio in 1987 in respect of long- and medium-term debt was about 62.3 percent, which was high even by international standards.

Since external debt incurred by the government was about 90 percent of the total, it is not diffficult to see that the main cause of this increasd indebtedness was the high level of government expenditure, particularly in sub-period 2. However, borrowings abroad by the private sector (including public corporations and government- owned business undertakings) have also shown a dramatic increase. This is perhaps not unusual in a period of burgeoning foreign trade, particularly in a liberalized trade and exchange regime. Thus in 1978 the external debt owed by the private sector was negligible; but by 1987 it increased to about 7 percent of the total. There was a corresponding decline in the share of external debt owed by the government from 99 percent in 1978 to 86 percent in 1987.

It is significant that the high Debt/GDP ratio did not lead to disruptive debt service payments in the eighties. This was because the concessionary element in the outstanding debt was high. Furthermore, in sub-period 2, the current account deficit was mainly one induced by relatively large inflows of concessionary capital for financing the Public Investment Programme, and hence the problem of managing it was not as serious as is suggested by the figures. The average Basic Balance in sub-period 2 was only -0.4 percent of the GDP. Except in the year 1980, when the balance of payments deteriorated to a dangerously low level, the Basic Balance remained above -1.5 percent of GDP, and was even positive in the year 1984.

It has often been suggested that Sri Lanka has failed to follow through a structural adjustment programme necessary to eliminate recurring balance of payments problems. Mere management of the external deficit, though necessary for short-term stability, is not a substitute for such adjustment. Structural adjustment in the present context consists of measures aimed at improving the allocative efficiency of the economy and, by its very nature, is a medium- to long-term process. There is no doubt that this comment is valid up to a point. However, the critics, often underestimate the structural adjustment that has already taken place. What has often happened in the period reviewed, was that whatever gains were made were wiped out by large adverse movements in the terms of trade. A certain amount of adjustment has been taking place all the time, even though the the balance of payments expressed in current prices shows only what appears to be a 'below the line' financing operation.

Data presented in Table 9 shed some light on the impact of the terms of trade movement on the external deficit. Row A2(c) shows that had the import and export prices remained at their 1970 levels, the foreign financing requirement in the period reviewed would have been neglegible. In fact, sub-period 1 would have ended with a surplus on the goods and non-factor services account amounting to 3.8 percent of GDP instead of a deficit of 2.7 percent. In sub-period 2 the same account would have shown a deficit equivalent to 1.2 percent of GDP instead of 12.9 percent. Thus, it is possible to conclude that, overall, the flow of external financing has done little more than compensate for the deterioration in the terms of trade. Such evidence need not be interpreted to suggest that no further attempts to adjust are required. Declining terms of trade is a reality. What is important is to understand the problem correctly and to approach its solution with foresight and ingenuity.

Table 9
Effects of Changes in the Terms of Trade on the External Balances

	1970-77	1978-87	1970-87
A. In Constant 1970 Prices			
1. Period Total SDR MI			
(a) Exports of Goods & NFS	3089	5555	8644
(b) Imports of Goods & NFS	2602	5862	8464
(c) Goods and NFS Balance	487	-307	180
(d) GDP at market prices	12964	25084	38048
2. Averages for the Period as percentages of GDP			
(a) Exports of Goods & NFS	23.8	22.1	22.7
(b) Imports of Goods & NFS	20.1	23.4	22.2
(c) Goods and NFS Balance	3.8	-1.2	0.5
B. In Current Prices			
1. Period Total SDR MI			
(a) Exports of Goods & NFS	3704	12083	15787
(b) Imports of Goods & NFS	4068	17648	21716
(c) Goods and NFS Balance	-364	-5565	-5929
(d) GDP at market prices	13655	43165	56820
2. Averages for the Period as percentages of GDP			
(a) Exports of Goods & NFS	27.1	28.0	27.8
(b) Imports of Goods & NFS	29.8	40.9	38.2
(c) Goods and NFS Balance	-2.7	-12.9	-10.4
C. Overall Gain(+)/Loss(-) SDR MI on Account of Changes in TOT [B1 (c) - A1 (c)]	-851	-5258	-6109
D. Terms of Trade Index (1970=100)			
(a) Beginning of Period	100	81.2	100
(b) End of Period	74.3	72.6	72.6

Source: Central Bank of Sri Lanka : Annual Reports, and Reviews of the Economy, relevant years.

One important instrument of balance of payments policy that has received a great deal of attention has been the exchange rate. It is perhaps unnecessary at this point to repeat the well-documented theory concerning its efficacy as a means of achieving either a short-term balance of payments stability, or a long term structural adjustment. One comment that would be appropriate would be that since Sri Lanka has experienced a rate of inflation higher than that of most trading partners and competitors in the period reviewed, a substantial adjustment in the exchange rate was unavoidable. Contrary to popular belief that such adjustment has been inadequate, the figures in Table 10 suggest that a substantial depreciation of the currency has indeed taken place. Thus, relative to the SDR, the Rupee in 1987 was 15.6 percent of its value in 1970 and relative to the US dollar, 19.3 percent. The real exchange value of the currency indicated by the difference in domestic and foreign inflation rates at its worst was only 26.2 percent against 100 in 1970. This suggests a considerable real depreciation during the period.

The analysis presented in Table 10, however, does not help to determine whether an equilibrium exchange rate has been achieved. All it attempts to show are the changes that occurred relative to the base year 1970. It is not unlikely that even in 1970 the nominal exchange rate was somewhat out of line with the equilibrium rate. It is also quite possible that some real appreciation took place in certain years [14]. Nevertheless, the overall picture is one of vigorous adjustment suggestive of an aggressive exchange rate policy.

V. PUBLIC FINANCE

Reference has already been made in the preceding discussion to the profound influence exerted by fiscal operations of the government on many of the macroeconomic variables. Public expenditure was an important element in the overall demand. This would have in turn influenced the flow of imports into the economy, determined the size and complexion of the capital account in the balance of payments, and consequently that of external debt. In addition, public finance operations played a crucial role in the determination of domestic savings. The government's unique position as the largest debtor institution influenced the financial asset structure in the country and, through it, the evolution of most monetary variables. Thus, it is not

surprising that economic stability, or the lack of it, was often attributed to the conduct of public financial policy. This is basically a way of looking at the short-term impact of public finance.

Table 10
Evolution of Real Exchange Rates

		1970	1977	1987
Price Indices 1970=100				
A. Sri Lanka GDP Deflator	(P)	100.0	218.2	712.7
B. Foreign Prices				
1. Exports	(PE)	100.0	182.1	186.5
2. Imports	(PM)	100.0	245.1	256.7
3. W.B. MUVI	(F1)	100.0	201.1	358.0
4. US GDP Deflator	(F2)	100.0	160.0	279.7
5. UK GDP Deflator	(F3)	100.0	242.5	557.7
6. Japan GDP Deflator	(F4)	100.0	185.8	230.3
C. Exchange Value of SL Rupee [a] Relative to				
1. Export Prices	(PE/P)	100.0	84.2	26.2
2. Import Prices	(PM/P)	100.0	113.4	36.0
3. W.B. MUVI	(F1/P)	100.0	93.0	50.2
4. US GDP Deflator	(F2/P)	100.0	74.0	39.2
5. UK GDP Deflator	(F3/P)	100.0	112.2	78.3
6. Japan GDP Deflator	(F4/P)	100.0	85.9	32.3
D. Nominal Exchange Rates [b] Foreign Currency Unit per Sri Lanka Rupee Index 1970=100				
1. SDR	(N1)	100.0	57.0	15.6
		(100)	(53.5)	(24.2)
2. US $	(N2)	100.0	69.2	19.3
		(100)	(65.9)	(30.0)
3. UK Pound	(N3)	100.0	92.0	25.0
		(100)	(86.4)	(38.7)
4. Japanese Yen	(N4)	100.0	48.4	6.6
		(100)	(45.5)	(10.3)

Sources: Central Bank of Sri Lanka : Annual Reports, and Reviews of the Economy, relevant issues.
Worlld Bank : Quarterly Revisions of Commodity Price Forecasts, relevant issues.
IMF : International Financial Statistics, Yearbooks, relevant issues.

[a] Hypothetical Exchange Value of the domestic currency (Real Exchange Rate) as indicated by relative price movements.

[b] The Official Exchange Rate. What is shown within brackets relates to the FEEC Rate under the dual exchange rate scheme.

In the longer term, public expenditure has exerted an important influence on the economic and social development of the country. In Sri Lanka, traditionally, the central government had played a leadership and catalyst role in almost all development activity and therefore, the decision makers often called for increased capital expenditure, which they regarded as being synonymous with economic and social development. The adverse short-term impact of excessive public expenditure was not usually understood.

Table 11 shows the movement of some of the key public finance variables in the 18 year period. The revenue of the government amounted to about 21 percent of GDP which is somewhat higher than the average for a low-income developing country. The recurrent expenditure has averaged about 19 percent of GDP. Thus, a modest surplus on the current account was maintained. As far as capital expenditure is concerned, there was a wide difference between the two sub-periods. Capital expenditure (including net lending) was about 7 percent of GDP in 1970-1977. This ratio more than doubled in the second sub-period, as a result of which the total expenditure of the central government reached a level which exceeded one-third of GDP. Some of the main characteristics of the two sub-periods may be summarised as follows:

Sub-period 1 could be described as one of relatively low overall expenditure, financed mainly from domestic non expansionary sources. Its contribution to the expansion of public debt was moderate. Thus, at the end of 1977, the total public debt outstanding was Rs 25 billion, which was equivalent to 69 percent of GDP.

In contrast, sub-period 2 was a period of high spending and large deficits. The overall budget deficit, after grants, rose to an average level of 10.4 percent of GDP, a major part (about 56 percent) of which was financed from domestic bank and non-bank sources. Foreign borrowing also showed a dramatic increase from the low levels of the previous period. On the whole, there was a considerable weakening of the financial position of the government : so much so that active measures to check the growth of public investment expenditure had to be taken, particularly in the years after 1980. Total public debt stood at Rs 189 billion, equivalent to 96 percent of GDP, by the end of the period.

Table 11
Government Fiscal Operations 1970-1987
Selected Years and Averages for the Two Sub-Periods

Rs. Billions
Percentage of GDP within brackets

	Selected Years for the Sub-Periods							Average		
	1970	1973	1976	1979	1982	1985	1987	1970-77	1978-87	1970-87
1. Revenue	2.7 (19.7)	3.7 (20.0)	5.3 (17.4)	12 (22.8)	16.6 (16.7)	37.2 (22.9)	42.8 (21.8)	4.1 (18.2)	24.7 (21.3)	15.5 (20.9)
2. Current Expenditure	2.6 (19.0)	3.5 (19.1)	5.2 (17.2)	10.9 (20.8)	19.0 (19.1)	32.3 (19.9)	37.2 (18.9)	4.0 (18.1)	22.0 (19.0)	14.0 (18.9)
3. Capital Expenditure + Net Lending	1.0 (7.3)	1.2 (6.4)	3.0 (9.9)	8.7 (16.6)	15.1 (15.2)	23.7 (14.6)	27.4 (13.9)	1.5 (7.0)	17.7 (15.2)	10.5 (14.1)
4. Total Expenditure	3.6 (26.3)	4.7 (25.5)	8.2 (27.2)	19.6 (37.4)	34.1 (34.4)	56.0 (34.5)	64.6 (32.8)	5.5 (24.7)	39.7 (34.2)	24.5 (33.0)
	0.9 (6.6)	1.0 (5.4)	2.9 (9.6)	7.6 (14.5)	17.5 (17.6)	18.8 (11.6)	21.8 (11.1)	1.4 (6.3)	15.0 (12.9)	9.0 (12.1)
6. Financing of Overall Deficit (a) Grants	* (0.0)	* (0.0)	0.4 (1.3)	1.4 (2.7)	3.4 (3.4)	3.3 (2.0)	4.7 (2.4)	0.2 (0.9)	2.9 (2.5)	1.7 (2.3)
(b) Domestic Non-Bank Borrowing	0.4 (2.9)	0.9 (4.9)	1.3 (4.3)	3.2 (6.1)	5.4 (5.4)	1.2 (0.7)	8.9 (4.5)	0.9 (4.0)	4.2 (3.6)	2.7 (3.6)
(c) Domestic Bank Borrowing	0.4 (2.9)	-0.1 (-0.5)	0.6 (2.0)	0.7 (1.3)	4.0 (4.0)	7.2 (4.4)	2.4 (1.2)	0.1 (0.4)	2.6 (2.2)	1.5 (2.0)
(d) Foreign Borrowing	0.2 (1.5)	0.1 (0.5)	0.6 (2.0)	2.3 (4.4)	4.7 (4.7)	7.1 (4.4)	5.7 (2.9)	0.3 (1.3)	5.3 (4.6)	3.1 (4.2)
7. Overall Deficit After Grants	0.9 (6.6)	0.9 (4.9)	2.5 (8.3)	6.2 (11.8)	14.1 (14.2)	15.5 (9.5)	17.1 (8.7)	1.3 (5.8)	12.1 (10.4)	7.3 (9.8)
8. GDP at market prices	13.7 (100)	18.4 (100)	30.2 (100)	52.4 (100)	99.2 (100)	162.4 (100)	196.7 (100)	22.3 (100)	116.0 (100)	74.3 (100)

Source: Central Bank of Sri Lanka: Annual Reports, and Reviews of the Economy, relevant issues; Estimates of Revenue and Expenditure of the Government of Sri Lanka, relevant issues; The General Treasury.

The latter period was perhaps an instance when government spending on development was raised to a point where a trade-off between economic stability and growth became a matter for active decision-making, rather than a mere theoretical possibility. For example, in 1980, the overall deficit in the central government budget and the current account in the balance of payments reached all time high levels of 21.7 percent and 19.8 per cent of GDP, respectively. Domestic credit increased by 72 percent and consumer prices increased by 26.1 percent. The build-up of public investment expenditure which led to this crisis of stability was, however, justified by decision-makers on the grounds that economic infrastructure facilities such as power, irrigation and communications, had to be developed within the shortest possible time, so that productive activity could be promoted on a scale required to absorb the large numbers of unemployed into the economic system. Thus, in the early years of sub-

period 2, there was a genuine sense of urgency which was further enhanced by the fact that a number of bilateral aid donors pressed for early implementation of their own projects for their domestic reasons.

The heightened activity helped to reduce the rate of unemployment to an appreciable extent. On the other hand, the implementation of such a large Public Investment Programme posed a number of problems. These arose primarily from the fact that the Public Investment Programme itself, despite its unprecedented size, was not a well planned one. Neither a serious study of its macroeconomic impact, nor of the full financing implications were made before the government made a firm political commitment to its implementation. Thus, even though the financing packages worked out with the respective donors appeared adequate at the beginning, subsequent developments, particularly the cost escalations brought about by high domestic and foreign inflation, rendered them grossly inadequate. Consequently, when large financing gaps in the programme appeared, the policy-makers were left with very few choices. This perhaps explains the sudden spurt in borrowing from domestic banks and from foreign sources, on commercial terms, in the period 1979-1983.

Table 12 shows that the structure of government revenue has not changed appreciably in the 18-year period. Non-tax revenues accounted for 2 to 3 percent of GDP, while tax revenues accounted for 16 to 18 percent. Of the tax revenues, the largest share came from taxes on foreign trade. However, taxes on domestic goods and services which include Turnover Taxes and Excise Duties have been increasing their share during the second sub-period, partly at the expense of the foreign trade taxes. This shift of the tax base towards domestic goods and services is perhaps the most noteworthy change that occurred during the period reviewed. Historically, foreign trade taxes have been the mainstay of Sri Lanka's revenue structure. Of these, of course, the export taxes concentrated heavily on the products of plantation agriculture. Given the importance of foreign trade in the economy of Sri Lanka, it is not therefore surprising that the Tax/GDP ratios were relatively high from the start. It has been suggested [8] that the foreign trade taxes, particularly the export duties, were regarded as a substitute for income taxes, the latter usually occupying a relatively less important position in terms of its contribution to the total collections. The share of taxes on income and profits has shown a tendency to decline in the sub-period owing

to the relatively generous tax exemptions granted to businesses as a part of the development strategy followed during this period.

Tax buoyancies estimated for Sri Lanka [8] have been generally less than one. Buoyancy parameters estimated for the present exercise [9] which relate to the aggregate tax revenue are 0.996 for 1970-77 and 0.885 for 1978-87. These suggest a marked decline in the overall tax buoyancy in period 2. There appears to be a built-in deficiency in the tax structure which retards the growth of tax revenues. One obvious cause is the excessive dependence on foreign trade. This however does not explain the decline in the tax buoyancy in the second sub-period. A further problem would have been the insufficient coverage of the 'growth sectors' -- particularly certain service activities and domestic agriculture.

Table 12
Structure of Government Revenue 1970-1987
Selected Years and Averages

Rs. Billions
Percentage of GDP within brackets

	1970	1973	1976	1979	1982	1985	1987	Average 1970-77	Average 1978-87	Average 1970-87
Total Revenue	2.7 (19.6)	3.7 (20.0)	5.3 (17.4)	12 (22.8)	16.6 (16.7)	37.2 (22.9)	42.8 (21.8)	4.1 (18.2)	24.7 (21.3)	15.5 (20.9)
(a) Non Tax	0.6 (4.0)	0.6 (3.3)	0.5 (1.7)	0.9 (1.7)	1.2 (1.2)	6.8 (4.2)	7.3 (3.7)	0.5 (2.3)	3.2 (2.8)	2 (2.7)
(b) Tax	2.1 (15.6)	3.1 (16.8)	4.8 (15.8)	11.1 (21.1)	15.4 (15.5)	30.4 (18.7)	35.5 (18.1)	3.6 (15.9)	21.5 (18.5)	13.5 (18.2)
Taxes on -										
1. Foreign Trade	1.1 (7.9)	1.3 (7.2)	2.2 (7.4)	6.7 (12.7)	5.9 (5.9)	11.3 (7.0)	13.6 (6.9)	1.6 (7.3)	9.2 (7.9)	5.8 (7.8)
2. Income and Profits	0.4 (3.2)	0.7 (3.8)	0.9 (3.1)	1.3 (2.6)	2.9 (2.9)	5.6 (3.4)	4.9 (2.5)	0.7 (3.0)	3.4 (2.9)	2.2 (2.9)
3. Property	* (0.4)	* (0.4)	* (0.3)	0.2 (0.3)	0.3 (0.3)	0.5 (0.3)	1.6 (0.8)	0.1 (0.3)	0.5 (0.4)	0.3 (0.4)
4. Domestic Goods and Services	0.6 (4.1)	1 (5.4)	1.5 (4.9)	2.9 (5.5)	6.3 (6.4)	13 (8.0)	15.4 (7.8)	1.2 (5.3)	8.4 (7.3)	5.2 (7.0)

Source: Central Bank of Sri Lanka: Annual Reports, and Reviews of the Economy, relevant issues; Estimates of Revenue and Expenditure of the Government of Sri Lanka, relevant issues; The General Treasury.

It is possible that the excessive dependence on foreign trade taxes have been detrimental to the allocative efficiency of the economy. They would have resulted in excessive protection to domestic industry as well as a disincentive to exports. It is also worth noting that, overall, the tax system has been progressive [8], even though there might have been room for improvement by increasing the share of direct taxes.

In the case of central government expenditure, the two sub-periods show marked differences (Table 13). The Total Expenditure/GDP ratio has increased from an average of 25.1 percent in sub-period 1 to 34.2 percent in sub-period 2. Available data on functional classification of government expenditure is somewhat deficient in coverage. However, approximate estimates suggest that the highest share of 64 to 66 percent of the total has gone into Economic Services which include irrigation, power, transport and telecommunications. Thus, the movement of the total has been influenced principally by expenditure on economic services. A comparatively recent development has been the buoyancy of defence expenditure. It has increased from an average of 3 percent of total government expenditure in the 1970-77 period to 9.3 percent, which is equivalent to about 3.1 percent of GDP (1987). This trend of course is explained by the deterioration in the general security situation of the country after the ethnic clashes of 1983.

Table 13
Structure of Government Expenditure 1970-1987

Rs. Billions
Percentage of GDP within brackets

								Averages		
	1970	1973	1976	1979	1982	1985	1987	1970-77	1978-87	1970-87
Total Expenditure [a]	3.7 (26.8)	4.7 (25.4)	8.2 (27.1)	19.6 (37.4)	34.1 (34.3)	56.0 (34.5)	64.4 (32.8)	5.6 (25.1)	39.7 (34.2)	24.5 (33.0)
1. Defence	0.1 (0.8)	0.1 (0.8)	0.2 (0.6)	0.4 (0.8)	0.5 (0.5)	4.6 (2.8)	6.0 (3.1)	0.2 (0.8)	1.9 (1.7)	1.2 (1.5)
2. Education	0.5 (3.8)	0.6 (3.3)	0.9 (3.0)	1.4 (2.7)	2.6 (2.6)	4.5 (2.7)	4.9 (2.5)	0.7 (3.1)	3.0 (2.6)	1.9 (2.6)
3. Health	0.3 (2.0)	0.3 (1.6)	0.5 (1.7)	1.0 (1.9)	1.2 (1.2)	2.1 (1.3)	3.4 (1.7)	0.3 (1.6)	1.7 (1.5)	1.1 (1.5)
4. Economic Services	2.3 (17.2)	3.1 (16.6)	5.6 (18.7)	13.9 (26.4)	21.5 (21.7)	34.0 (20.9)	36.2 (18.4)	3.7 (16.5)	25.4 (21.9)	15.7 (21.2)
5. Other Govt.Services	0.4 (3.0)	0.6 (3.1)	0.9 (3.1)	2.9 (5.6)	8.3 (8.4)	10.8 (6.7)	14.1 (7.2)	0.7 (3.1)	7.7 (6.6)	4.6 (6.2)

[a] Sum of Current and Capital Expenditure including Net Lending
Source:Central Bank of Sri Lanka: Annual Reports and Reviews of the Economy, relevant issues.

One other noteworthy change in the structure of government expenditure is the decline in the share of social expenditure, particularly education. Expenditure on education declined from 3.1 percent of GDP in sub-period 1 to about 2.6 percent in sub-period 2, while that on health declined marginally from 1.6 percent. to 1.5 percent. This change perhaps is not attributable to any conscious change in policy, but to the fact that the government committed itself to large expenditure on developing economic services which were supported by foreign aid, and social expenditure, which was generally not so well supported, became vulnerable when the need arose to cut back budgetary expenditures for reasons of improved financial management.

VI. INCOME AND EMPLOYMENT

Important changes in income and employment can take place only in the medium- or the long-term. However, short-term economic stability exerts an influence on them. Therefore, it may be useful to outline some aspects of their movement in the period reviewed.

From the beginning of the period reviewed, Sri Lanka was identified as a low-income country by world standards. Unemployment had reached almost crisis proportions in the early 1970s. On the other hand, the country already had a reputation as a high performer on social welfare indicators, this fact itself suggesting a relatively advanced egalitarian outlook.

In 1970 the per capita income stood at Rs 924 (US$100). It had increased in current price terms to about Rs 10,598 (US$360) by 1987. During this period there was a tendency for income disparities to worsen, and particularly in the second sub-period. For instance, the Central Bank's Consumer Finance Surveys showed that the share of income enjoyed by the highest decile increased from 30 percent in 1973 to 42 percent in 1981-82, while that of the lowest decile declined from 5 percent to 4 percent. [10] The estimates of the Gini Coefficients for income receivers, as well as for spending units, indicate a similar trend.

The Socio Economic Survey (SES) of 1969-70 [11] estimated the labour force of Sri Lanka to be about 4.169 million. This number apparently grew at an annual average rate of about 2.7 percent between 1971 and 1980, this being a much

lower rate than that observed for the period 1963 and 1971 [12]. The customary explanation given for the slowing-down is the migration of Sri Lankan workers for employment abroad and the repatriation of workers of Indian origin in this period.

The total employed population according to the SES 1969-70 was 3.61 million, giving an open unemployment of 0.559 million or 13.4 percent. In the next decade, the total employment grew at an average rate of 2.7 percent which was slower than the growth of the labour force. Thus, by 1981 the backlog of open unemployed increased to about 15 percent of the labour force. There were indications, however, that a modest reduction in this rate occurred in the early eighties, even though numerical estimates vary widely due to differences in definition and coverage of the surveys and censuses conducted. However, by 1987, it could safely be assumed that the rate of open unemployment had risen again to 16 percent or more according to crude estimates available.

One important characteristic of Sri Lanka's unemployment problem was that most of the unemployed were young (aged 20-29 years). Over the years, unemployment in this group had actually increased. A related, but distinct feature, was that groups with higher educational attainments tended to be more severely affected than the others. Surveys also indicate that unemployment among females has been growing faster than among the males.

The changes in the rate of unemployment in the 1980s, point to the conclusion that even though exceptionally high levels of government expenditure in the beginning of the period brought some relief, a return to more sustainable levels in the later years aggravated the unemployment problem again. This is not surprising, since a large share of such expenditure went into projects which did not create many employment opportunities directly, except on a temporary basis in construction. A different mix of public expenditure projects would have been more advantageous for achieving the employment objective. A recent study by the World Bank [13] has found that the Accelerated Mahaweli Programme, in particular, had not been an efficient user of capital, when compared with smaller multipurpose projects. It follows that its opportunity cost in terms of employment generation has also been high.

The aggravation of the unemployment problem in the latter period was also linked to a movement towards greater rationalization of the manufacturing sector in the

country in the wake of liberalization of trade and exchange. A number of public sector enterprises, which had earlier thrived in a protected domestic market, had to curtail operations, and a large number of private, small-scale handloom textile manufacturers, ceased operations. Apparently, the new job opportunities created in trade, services, and in the new manufacturing enterprises, particularly in the Investment Promotion Zones, did not compensate for all such losses, at least in the short-run.

A somewhat obvious conclusion that may be drawn here is that an increase in public expenditure *per se* may not be the answer to the problem of unemployment. What may be important is a well-planned public investment programme designed to have adequate impact, both direct and indirect, on employment.

It is reasonable to assume that the high inflation and associated economic instability of the early eighties affected, adversely, income distribution as well as employment, independently of other changes. Its negative impact on incentives to export, and on the international competitiveness of local industry, among other things, would have retarded the achievement of a full production potential in the period considered. From the advantage of hindsight it can be seen that, had the country been able to reach the overall investment ratio that was achieved abruptly in 1980, through a more gradual process, over a period of some years, many of the evils associated with economic instability could have been avoided and, consequently, a more stable rate of growth in production and employment could have been achieved.

VII. PRICE MOVEMENTS AND MONETARY GROWTH

In terms of the somewhat imperfect consumer price index [The Colombo Consumers' Price Index (CCPI)], Sri Lanka's average rate of growth of consumer prices in the period 1970-87 had been 9.6 percent. This rate simply represents the growth between the two end-points. The Least Square trend, however, gives a slightly higher average rate of 10.5 percent. These averages lie somewhere between the average consumer price growth rate of the Industrial Countries on the one hand, and that of the World, on the other. Almost all general price level indicators for Sri Lanka show that this particular period was characterised by short periods of price instability alternating with shorter spells of relative stability. Thus, in 1971-74, 1977-1980 and 1982-84 the growth of prices accelerated and in the rest of the period it slowed down.

It is perhaps unnecessary, in the context of this paper, to discuss in great detail the processes that determined the particular behaviour of the general price level. However, it may be appropriate to explain at least some of the movements in terms of other known events. It may be easily seen that the two 'Oil Price Shocks' were partly responsible for the sharp upward movements in 1973, 1974, 1979 and 1980. Similarly, the collapse of the oil prices in 1985-87 exerted some moderating influence on the domestic price levels in the same period.

Chart 4, which is intended to compare the movement of the CCPI and the GDP deflator with the movement of a representative international price index, reveals a particularly interesting relationship. It shows that from 1970 to 1979 both the CCPI and the GDP deflator moved at a rate similar to that of the World Bank's Manufacturing Unit Value Index (MUVI), which has been taken as an indicator of 'imported inflation'. However, after 1979, the domestic price indices began to swing upwards, giving a rather strong indication that domestic factors dominated their behaviour during this period. Even a comparison with other indicators of international prices points to a similar conclusion [13]. It may be recalled that the latter movement occurred more or less during sub-period 2, when certain policy changes leading to large divergences between aggregate supply and aggregate demand arose. It may be noted that despite the 'inward looking policies' adopted in sub-period 1, the country managed by and large to contain price movements within limits imposed by external factors.

It may be useful to view the movements of monetary aggregates against the background of the changes in domestic price levels. Table 14 shows that there were marked differences in the growth of Domestic Credit from the banking system in the two sub-periods. Thus in sub-period 2, total Domestic Credit grew at an average rate of 24 percent per annum which was more than twice the rate observed in sub-period 1. It appears that credit to both Government and Non Government Sectors expanded rapidly while the share of the Non-Government sector increased slightly faster than that of the Government. If the Public Sector is defined as including the state corporations as well, the same broad pattern prevailed.

Table 14
Selected Monetary and Price Variables
Average Rates of Change

	Percentages		
	1970-77	1977-87	1970-87
1. Narrow Money Supply (M1)	15.1	16.7	16.0
2. Velocity M1	-0.1	1.5	0.8
3. Broad Money Supply (M2)	15.7	20.9	18.7
4. Velocity M2	-0.6	-2.1	-1.5
5. Domestic Credit			
(a) Total	11.2	24.0	18.6
(b) To Government	2.2	24.6	14.9
(c) To Government and Public Corporations	7.2	22.1	15.7
(d) To Non Government [a]	17.6	25.9	22.4
6. Price Indices			
(a) Consumer (CCPI)	5.7	12.3	9.6
(b) Wholesale [b]	10.6	11.9	11.5
(c) GDP Deflator	11.8	12.6	12.2

Sources: Central Bank of Sri Lanka: Annual Reports and Review of the Economy, relevant issues; Department of Census and Statistics.
[a] Excludes Public Corporations
[b] Series starts in 1974. Therefore, the average in column 1 refers to period 1974 to 1977

In the early years of the period reviewed, net credit to the government from the banking system was about 61 percent of total domestic credit, but by the end of the period this had declined to about 36 percent. Meanwhile, gross credit to the private sector increased from 32 percent to 54 percent. The share going to the public corporations began to assume some importance from around 1974. Yet, it also showed a decline, particularly since 1979. Expressed as a percentage of GDP, the share of Domestic Credit taken by the public sector (government + state corporations) showed a marked decline in the 1970-77 sub-period. In the second sub-period there was some recovery, particularly in 1980-84, during which government spending reached an all time high level relative to the GDP.

It is important to note that, despite the preeminent position occupied by the government as a beneficiary of Domestic Credit, borrowing by the private sector was the major cause of expansion of Domestic Credit throughout the period. Thus, during the 18-year period, 55.8 percent of the increase in Domestic Credit was on account of private sector (excluding state corporations) borrowing. The share was even higher in

sub-period 1. Thus, credit to the private sector appears to be the more volatile element in the process of credit expansion.

In the period up to 1976, the changes in the external assets of Sri Lanka did not play any important role in overall monetary expansion. Generally speaking, they exerted only a small, negative influence. However, from 1976, there was a rapid build-up of external assets caused initially by the sudden improvement in the terms of trade and subsequently on account of increased mobilization of foreign capital under the new policy dispensation. In general, the effect of this accumulation was expansionary, and its size much larger than hitherto.

Movements of the total money supply variables were related mainly to the two sets of factors discussed above, namely, Domestic Credit Expansion and External Banking Assets. Changes in the third set of factors, namely, Net Other Liabilities, have grown in importance recently. However, they are not taken up for discussion in the present paper.

Table 14 shows that Narrow Money Supply aggregate (M1) grew at an average rate of 16 percent per annum in the 18-year period under review. Since the GDP in current prices grew at an average rate of 17 percent, it follows that there has been a small increase in the velocity of circulation. That this increase came entirely in period 2 is significant in view of the situation of instability during this period. The case of Broad Money Supply (M2) is somewhat different in that it grew at an average rate of 18.7 percent in the period reviewed, thus showing a decline in the corresponding velocity amounting to 1.5 percent per annum. Here again, the decline came mainly in sub-period 2. Thus, in the second sub-period, a substantial growth in quasi-money would have occurred. This was indeed the case as commented upon in the section on Investment and Savings.

The profile of nominal interest-rate movements shows a relatively stable situation in sub-period 1 followed by a rather sharp upward movement between 1977 and 1983, after which there is a moderate downward movement. It is clear that in the pre-1977 period, the country followed a policy of low interest rates which was very much influenced by the exigencies of government borrowing. In contrast to this, the policy in the second sub-period was one of ostensibly high interest rates which were somewhat more flexible and responsive to apparent changes in supply and demand for

funds. As commented upon earlier, Domestic Savings did not respond adequately to the movements of the interest rates. Nevertheless, in this period, the interest-rate policy implicitly aimed at maintaining a positive real interest rate for deposits.

There were also other differences related to monetary policies adopted in the two periods. Commercial bank credit to the private sector was controlled on a selective basis in sub-period 1. The monetary authorities directed the commercial banks to restrict movement of credit to 'non-essential' activities which included borrowing for current consumption and speculative stock maintenance. In sub-period 2 the approach was somewhat more comprehensive, in that a larger variety of policy instruments were used. In 1980, the Central Bank started to plan allocation of credit under a National Credit Plan. Broadly, the approach here has been to plan and monitor the allocation of credit by the commercial banks to the private sector, taking as given the credit needs of the government and the change in the External Banking Assets which affect the overall money supply. The allocation has been made in terms of predetermined 'priority sectors'. This approach had its own merits as well as weaknesses. It was noted earlier that credit to the private sector happened to be the more volatile element in the Domestic Credit Expansion process in the recent period. Given this position, and the importance attached to activities of the private sector in the existing policy dispensation, it was sensible to pay special attention to the allocation of credit to the private sector. However, it had the disadvantage of a partial planning approach in which the entire area of government budgetary operations was effectively left out of the National Credit Plan.

VIII. CONCLUSIONS

Thus the economic reforms initiated in 1977 apparently set in motion certain trends in macro-economic variables, some of which were not necessarily favourable to accepted goals of economic and social development, specifically to overall economic stability.

Instability, as reflected in sharp increases in consumer prices, interest rates and wage rates, on the one hand, and increases in external debt and depletion of external resources, on the other, were the result of internal and external imbalances. The evidence presented in the paper strongly suggests, that in some cases at least,

such imbalances were policy-related. Consider, for example, management of public finance during the sub-period 1977-87 and particularly in the years 1980-82. During this period, the government's budget deficit increased beyond sustainable limits and for the first time the government resorted to foreign borrowing on commercial terms for budgetary financing. This situation arose mainly as a result of a commitment to an oversized public investment programme without careful prior evaluation of its costs and benefits.

However, not all the causes of the imbalances were policy-related. There was a considerable deterioration in the terms of trade. The deterioration in the terms of trade was such that the large inflows of external capital in this period barely compensated for such losses (Section 4). There was also pressure on the government finances caused by increased expenditure on defence. Thus, the main sources of instability in this period are two : policy and external factors. Some analysts would say that, in the final analysis, policies are to be blamed as they should have been dynamic enough to adjust to changes in external conditions.

The discussion also noted that, at least in one particular instance, policies have shown a considerable dynamism. This refers to the adjustment of the exchange rate. The analysis in Table 10 suggests that very sharp adjustments have indeed taken place; and it is even possible that the exchange rate adjustments themselves would have fed back into inflation and further instability. Ironically, this places the blame again on policy.

In the 1977-87 period, success was achieved in two areas of economic activity, albeit for a short period, namely, economic growth and employment. The question was raised in the introductory paragraph whether the same economic growth could have been achieved at a lesser cost in terms of economic stability. The answer to the question must be in the affirmative, if the position that there were avoidable shortcomings in policy is accepted. The evidence suggests that it was indeed the case.

NOTES

[1] This is the Least Square trend growth. The average compound growth rate between the two end-points is 4.2 percent.

[2] According to Customs data for the respective years, as quoted in the Statistical Year Book put out by the Department of Census and Statistics.

[3] See Reference (2).

[4] The Simple Regression analysis used the following specifications and data:

(i) Short Run MPC $Ct = a1 + b1\ Yt$

(ii) Long Run MPC $Ct = a2 + b2\ Yt + b3\ Ct\text{-}1$

where C = Private Consumption + Public Consumption in constant 1970 prices

Y = Gross Domestic Product in constant 1970 prices

Data: Central Bank of Sri Lanka - National Income Series.
Conversion to constant prices was by means of the implicit GDP(mp) deflator.
Regression Estimates : Short Run mpc

a1 = -29.2

R squared = .98

b1 = .867 (Se = .030)

Therefore short run mps = 1- .867 = .133

Long Run MPC
a2 = 55.2

b2 = .730 (Se = .174) R squared = .99

b3 = .162 (Se = .209)

Therefore, long run MPC = b2 /(1-b3)
= 0.871

This gives a long run MPC = 0.129

[5] See Reference (1)

[6] Financial Savings are defined for the present purpose as the annual increment in Fixed (Time) and Savings Deposits at the National Savings Bank and the Commercial Banks.

[7] Particularly in the years 1980, 1985, 1986 and 1987, when the overall Balance assumed large negative values.

[8] See Reference (3)

[9] The Simple Regression Analysis for estimating overall Tax Buoyancy was based on the following specification.

Log T = a + log Y

Where : T = Total tax revenue of the Central Government.
Y = GDP at current market prices.

The results of the two sub-periods are shown below :

1970-1977	1978-1987
a = -0.780 (Se=.1774)	a = -0.149 (Se = .3791)
b = 0.996 (Se=.0410)	b = 0.885 (Se = .0749)
R squared = .99	R squared = .95

[10] See Reference (4)

[11] See Reference (5)

[12] See Reference (6)

[13] See Reference (7) in particular, Annex 7 of Vol.II

[14] See Reference (8)

Chart 1
Movement of GDP and Domestic Absorption
Rs. Billion at Constant (1970) Prices, 1970-1987

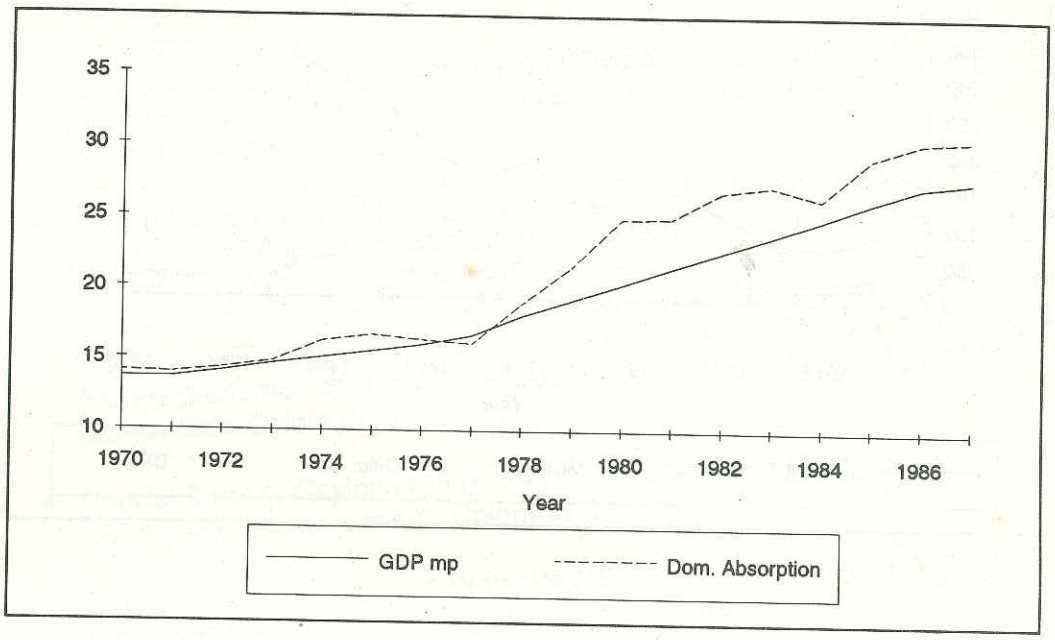


Chart 2
Selected External Balances As Percentage of GDP
1970-1987

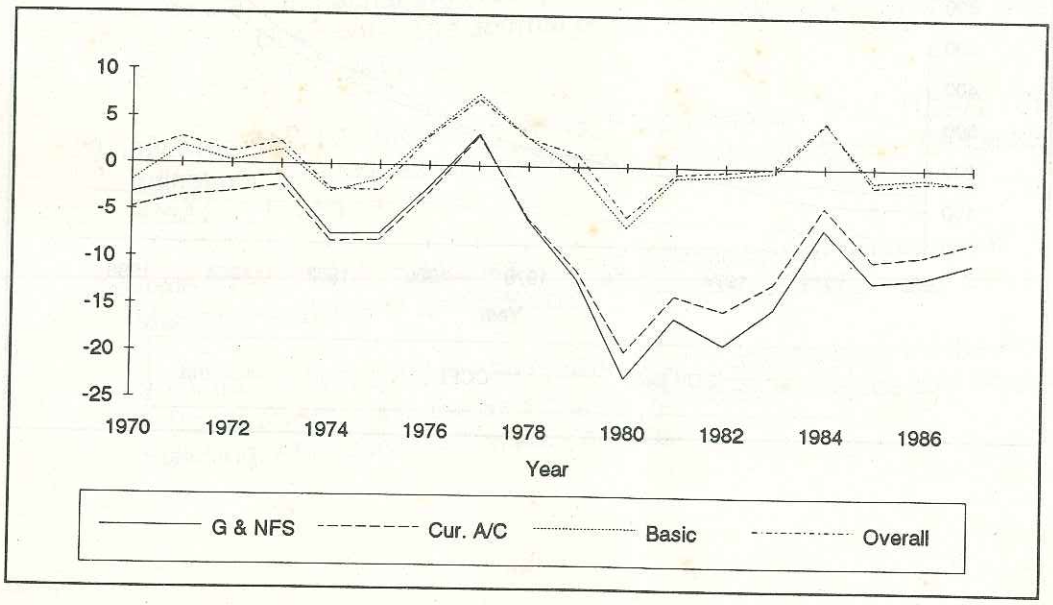


Chart 3
Selected Capital Inflows, 1970-1987

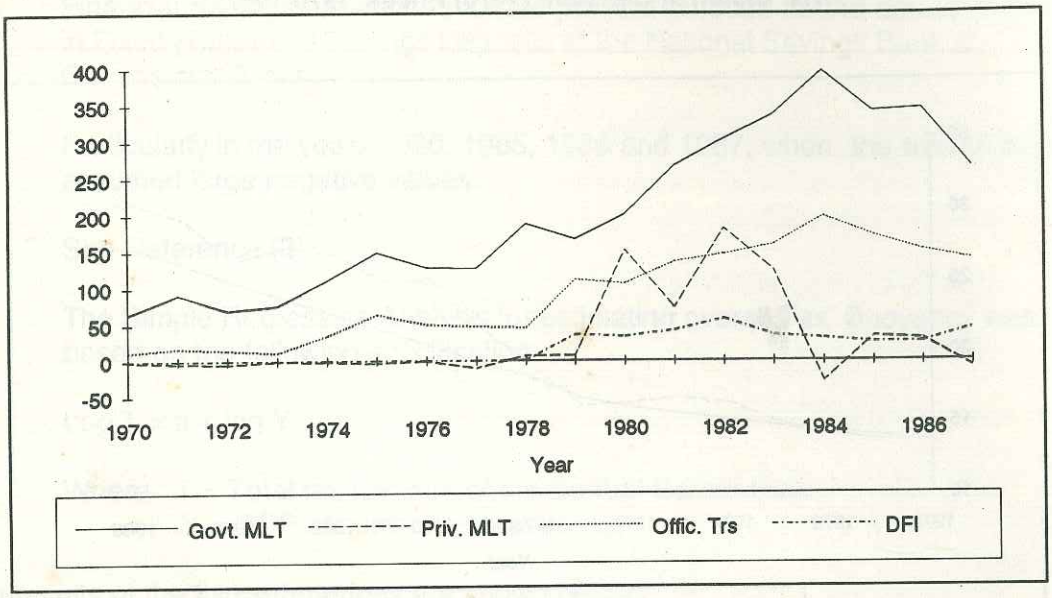
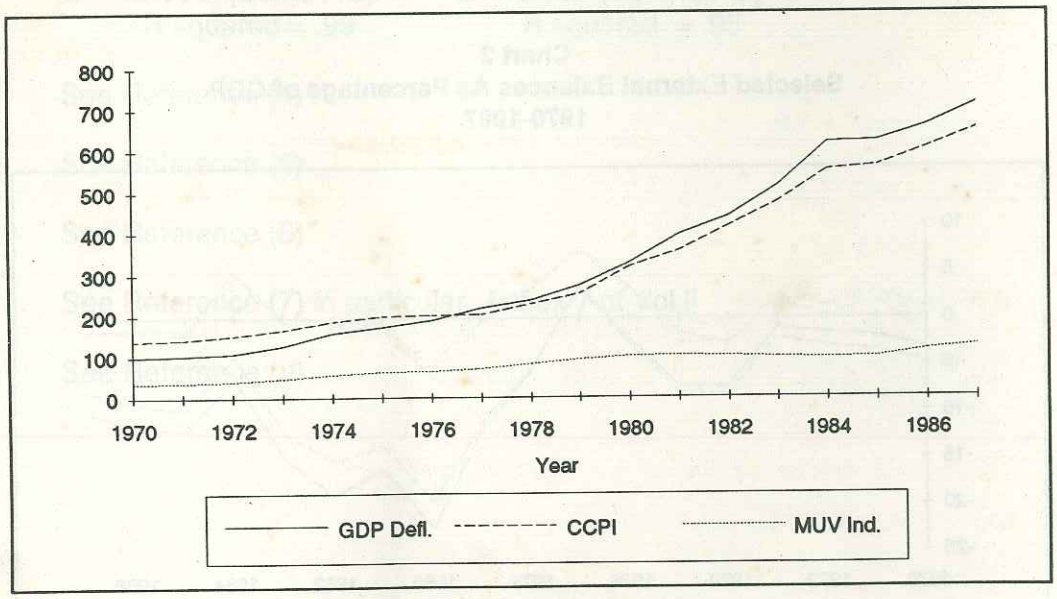


Chart 4
Selected Price Indices, 1970-1987



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APPENDIX TABLE A1

Current Balances in the Balance of Payments

SDR Millions
Percentages of GDP within brackets

	1970	1973	1976	1979	1982	1985	1987	Average 1970-77	Average 1978-87
1. Trade (Merchandise)	-53 (-3.6)	-39 (-2.7)	-73 (-3.9)	-362 (-13.9)	-890 (-20.6)	-711 (-12.1)	-525 (-10.2)	-68.4 (-4)	-598.1 (-13.9)
2. Goods & NFS	-47 (-3.2)	-17 (-1.2)	-43 (-2.3)	-313 (-12)	-822 (-19)	-719 (-12.2)	-522 (-10.1)	-455 (-2.7)	-556.5 (-12.9)
3. Goods & Services	-70 (-4.7)	-32 (-2.2)	-61 (-3.2)	-325 (-12.5)	-903 (-20.9)	-844 (-14.4)	-646 (-12.5)	-62.4 (-3.7)	-639.8 (-14.8)
4. Current Account Before O Transfers	-71 (-4.8)	-32 (-2.2)	-55 (-2.9)	-288 (-11.1)	-663 (-15.4)	-582 (-9.9)	-404 (-7.8)	-60.9 (-3.6)	-454.7 (-10.5)
5. Current Account After O Transfers	-51 (-3.4)	-21 (-1.4)	-5 (-0.3)	-177 (-6.8)	-516 (-11.9)	-410 (-7)	-265 (-5.1)	-29.5 (-1.7)	-318 (-7.4)
GDP at Current Market Prices	1482	1468.8	1881.7	2602.4	4318.5	5876.8	5163.3	1706.9	4316.5

Source: Central Bank of Sri Lanka